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Summary of the *Economic Survey of Europe, 2005*: the economic situation in Europe and the Commonwealth of Independent States in 2004-2005

Executive summary

The report provides a summary of the assessment of main economic developments in 2004 and the short-run outlook in the Economic Commission for Europe (ECE) region that was published in the *Economic Survey of Europe, 2005 No. 1*. It highlights major developments in 2004 and the macroeconomic developments in the ECE subregions, namely in Western Europe and the New EU-10, South-East Europe, and the Commonwealth of Independent States (CIS). It reviews the short-term outlook, which is still a favourable but somewhat less supportive international economic environment. It explores some selected policy issues such as structural reforms and macroeconomic policy framework in Europe; the policy challenge of economic diversification in the Commonwealth of Independent States (CIS); financial vulnerability in the ECE emerging market economies; and the upcoming challenges posed by globalization.

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I. Major developments in 2004

A strong global recovery

1. The global economic recovery maintained strong momentum in 2004. World output increased by some 5 per cent compared with the preceding year. That was the fastest average annual rate of increase in 30 years. The sharp rise in oil prices appears to have dampened global economic activity only moderately in the course of 2004.

2. The United States of America and China remained the principal engines of global growth. The continued dynamism of the Asian emerging market economies stood out. In contrast, in Japan, the recovery faltered after the first quarter of 2004. There has also been remarkably rapid growth in the CIS, largely because of the boom in commodity prices. Economic activity also picked up strongly in Latin America. In most of central and eastern European countries, economic activity continued at high momentum. The euro area, as in 2003, remained the laggard of the global recovery.

3. Global inflation remained moderate despite the significant upward pressures on energy prices. The so-called second round effects of higher energy prices were largely absent, a reflection of continued wage moderation and the credibility attained by monetary authorities to stem any nascent inflationary spiral.

4. The continued moderate inflationary expectations were a factor in the persistence of very low long-term interest rates in the international capital markets. Emerging markets continued to benefit from favourable financing conditions, with risk premia remaining at very low levels. Net private capital flows to developing and emerging markets rose to their highest level since the East Asian crisis.

5. A matter of strong concern is the widening of external imbalances among major economies and regions in the world economy. The large United States current-account deficit increased further to a level corresponding to 5.75 per cent of gross domestic product (GDP) in 2004. The main counterparts to that deficit are large current-account surpluses in Japan and Asian emerging markets and to a lesser extent in the euro area (mainly Germany). Redressing those global imbalances without disruptive changes in international capital flows and exchange rates among major currencies will require appropriate national and international economic policy responses.

Strong domestic demand continued to drive United States recovery

6. In the United States, economic activity grew at a brisk pace in 2004, driven by domestic demand. Exports picked up in a favourable external environment and helped by the weaker dollar. But the ongoing surge in imports meant that the change in real net exports continued to be a drag on domestic output. Real GDP rose by 4.4 per cent, significantly above the trend rate of output growth of some 3.25 per cent; as a result, the gap between potential and actual output became quite small in 2004. Private consumption, supported by a slowly recovering labour market, low interest rates and the wealth effect from the booming housing market, was the mainstay of economic activity. The personal savings rate remained at a very low level. Business spending on equipment and software was buoyant, stimulated by significantly improved corporate profits, higher capacity utilization rates and tax incentives. The

recovery, with an unusually long lag, was also reflected in an upturn of employment, although that was relatively subdued by historical standards. Consumer price inflation edged up somewhat, largely because of higher energy prices. The trade and current-account deficit surged to record levels in 2004.

7. Against the background of robust economic growth, the Federal Reserve started to gradually raise the target for the federal funds rate. But monetary policy remained still very supportive of economic growth. Moreover, the moderate tightening of monetary policy was offset by the further depreciation of the dollar, entailing overall very accommodative monetary conditions. At the same time, long-term interest rates remained very low. Following two years of strong fiscal stimuli, fiscal policy was only slightly expansionary in 2004. The general government budget deficit corresponded to more than 4 per cent of GDP in 2004.

Euro area recovery lost momentum

8. In the euro area, the cyclical recovery lost significant momentum in the second half of 2004. Export growth, which had been leading the recovery, weakened against the background of a moderate slowdown in the global economy and the adverse effects of the appreciation of the euro on price competitiveness. Domestic demand was sluggish and consequently lacked the vigour to offset the weakening of external demand. Private household consumption remained lacklustre, held back by low consumer confidence and modest growth in real wage incomes, also reflecting the sluggish employment recovery. Fixed investment picked up somewhat in 2004, but failed to gather significant momentum. Business fixed investment was held back by uncertainties regarding the medium-term outlook for demand as well as the surge in oil prices. That appears to have offset the potentially better conditions for investment spending owing to continued progress in redressing corporate balance sheets, supportive financial conditions, and improved profitability on the back of a cyclical recovery in productivity combined with wage moderation. In the event, real GDP rose by some 2 per cent in 2004 compared with the preceding year. The average outcome masks quite some variation in the growth performance of the individual member countries of the euro area, ranging from increases in real GDP by little more than 1 per cent in Italy, the Netherlands and Portugal, to buoyant growth of 4 per cent and more in Ireland and Luxembourg (see below, table 1.1.1). Germany, the major economy of the euro area, witnessed a return to positive average annual growth in 2004, following two years of virtual stagnation.

9. Consumer price inflation in the euro area has remained moderate in 2004, averaging slightly above 2 per cent. Upward pressure on the headline inflation rate came from the sharp rise in energy prices and increases in administered prices and indirect taxes. But that was offset by favourable price developments for other items — notably, a decline in prices of unprocessed food. Core inflation, which excludes prices of energy products and unprocessed food, was broadly the same as headline inflation in 2004. Owing to stronger productivity increases in combination with continued wage restraint, unit labour costs (in the whole economy) rose only slightly in 2004.

10. Labour markets in the euro area remained generally weak. Employment rose by only about 0.5 per cent higher in 2004 compared with the preceding year. The unemployment rate edged up further to nearly 9 per cent in 2004, compared with an average annual low of 7.8 per cent in 2001.

11. Economic activity in the euro area continued to be supported by low interest rates. In view of the fragile cyclical growth forces and moderate inflationary expectations, the European Central Bank has left its main refinancing rate unchanged at 2 per cent since June 2003. Real short-term interest rates were close to zero for most of 2004. Interest rates also remained very low at the longer end of the maturity spectrum. In the bond markets, average yields on 10-year euro area government bonds peaked at 4.4 per cent in June 2004, but fell below 4 per cent in the final quarter of 2004. But the further real effective appreciation of the euro led to some tightening of monetary conditions in the second half of 2004.

12. Fiscal policy in the euro area was slightly expansionary in 2004, as indicated by a small decline of the surplus on the cyclically adjusted primary balance. The actual general government budget deficit averaged some 2.75 per cent of GDP in 2004, broadly unchanged from the preceding year. Budget deficits were significantly above the threshold of 3 per cent (fixed in the Stability and Growth Pact) in France, Germany and especially Greece.

Favourable growth performance in other western European economies

13. In the United Kingdom, the cyclical recovery maintained relatively strong momentum in 2004. Real GDP rose by somewhat more than 3 per cent compared with 2003. Private consumption was again the mainstay of economic growth, supported by wealth effects originating in the housing market boom. But higher interest rates, associated with the gradual tightening of monetary policy, appear to have had a somewhat cooling effect on the housing market, as suggested by the deceleration of house price increases in the second half of the year. Gross fixed capital formation also rose strongly in 2004. Robust economic growth has gone along with a further increase in the demand for labour; at the same time, the unemployment rate fell to a record low. Revised estimates show that the stance of fiscal policy was broadly neutral in 2004, following two years of strong fiscal stimulus. The general government budget deficit in 2004 was slightly above the 3 per cent threshold stipulated in the European Union's fiscal rules.

14. In the other EU countries outside the euro area, economic growth recovered strongly in Denmark and Sweden in 2004, with output rising at a rate above its long-term trend. Economic performance in the western European economies outside the EU (Iceland, Norway and Switzerland) was also quite favourable in 2004. All told, real GDP in western Europe as a whole rose by some 2.25 per cent in 2004 compared with the preceding year.

Central and eastern Europe preserved a positive growth differential vis-à-vis western Europe

15. Economic activity in the eight new EU member States from central and eastern Europe (EU-8) picked up noticeably in 2004. Their aggregate GDP grew by some 5 per cent led by a strengthening recovery in Poland. All Baltic economies continued to grow at a brisk pace. In 2004, growth in the EU-8 economies became more broadly based, driven by robust consumption and investment expenditures and strong external demand. Import growth was dynamic, reflecting strong domestic demand and exports. Net exports continued to make a positive contribution to GDP growth in Poland and Slovakia but their impact remained negative elsewhere. Macroeconomic policies were broadly supportive of growth. Good fiscal outcomes

allowed the central banks to maintain accommodating monetary conditions. However, despite the acceleration of output growth, net job creation was rather weak while unemployment declined slightly. The duality of the labour market is apparent in skilled-labour bottlenecks coexisting with the absence of vacancies for the low-skilled jobseekers who dominate the pool of long-term unemployed. Inflation in the EU-8 countries increased slightly, largely reflecting one-off factors related to the EU accession as well as the rising prices of imported energy.

16. Economic growth in south-east Europe also accelerated considerably, underpinned by strong domestic demand and exports. Aggregate GDP rose by some 8 per cent (see below, table 1.1.2) on the strength of the recovery in the region's largest economies, Romania and Turkey. Some countries in the region (in particular the EU candidate countries Bulgaria, Croatia and Romania) continued to benefit from a surge in inward foreign direct investment, which has contributed to a deepening of the restructuring and modernization of their economies and acceleration of export growth.

17. In 2004 employment grew in Bulgaria but remained stagnant in Croatia and even declined somewhat in Romania. The situation in the labour markets of the remaining countries generally deteriorated in 2004, with some countries facing excessively high unemployment rates. Disinflation continued in most countries in 2004 reflecting relatively tight fiscal policies and in some cases, nominal effective exchange rate appreciation. However, several economies still face important macroeconomic policy challenges such as large fiscal deficits (Romania and Serbia and Montenegro) and current-account deficits (most south-east European economies). Croatia has been experiencing a chronic twin deficit.

For a second consecutive year the CIS was one of the fastest growing regions in the world

18. With GDP increasing by almost 8 per cent, the whole CIS region, including the largest economy, Russia, continued to benefit from the surge in world commodity prices. In most resource-rich CIS economies, the main factor behind their output growth was the rapid growth of commodity exports (particularly oil and natural gas). At the same time, several years of strong output growth have been associated with a surge in domestic demand, especially private consumption. In many countries, fixed investment has also recovered, most of it in extractive industries. Total employment in the CIS has continued to increase since the last quarter of 2003; however, this mainly reflects developments in some of the largest economies (foremost Russia). Towards the end of 2004, the number of involuntarily unemployed in the CIS averaged some 10 million people, accounting for 8 per cent of the economically active population in the region.

19. Macroeconomic policy in many CIS economies was expansionary, which gave a further boost to economic activity. The pro-cyclical bias in public spending became apparent in some countries in 2004, resulting in a deterioration of their structural fiscal balances. One consequence, however, was that rates of inflation began to fall more slowly, and in some cases there was also a deterioration of fiscal balances. Cost pressures have intensified with labour costs rising faster than producer prices. The strong recovery in consumer demand is likely to fuel further inflationary pressure. The currencies of most commodity-exporting economies were under growing pressure to appreciate as a result of their surging export revenues.

The symptoms of the "Dutch Disease" are increasingly evident in some economies, particularly Russia, putting monetary management under considerable strain.

II. The short-term outlook

A still favourable but somewhat less supportive international economic environment

20. Global economic growth is expected to slow down in 2005, but it should still average some 4.25 per cent. Robust growth of world trade will continue to rely on China and the United States as the main locomotives of that growth.

21. In the United States, real GDP is forecast to increase by some 3.5 per cent in 2005, down from 4.4 per cent in 2004 (see below, table 1.1.1). The rate of growth will still remain slightly above potential in 2005. Overall, activity will be supported by the continued, albeit moderating, strength of domestic demand. Exports should be stimulated by the depreciation of the dollar and by strong external demand in the United States major markets in Asia and Latin America. But imports will also rise and so the change in real net exports will continue to act as a drag on economic activity. The Federal Reserve is expected to continue gradually raising short-term interest rates to move monetary policy closer to a neutral stance during 2005. Fiscal policy will be slightly restrictive in 2005.

Continued growth in Europe and the CIS but at different rates

22. The short-term outlook for Europe and the CIS is for economic growth to continue in 2005, albeit at significantly different rates in the major subregions. The euro area will continue to lag behind the other major regions of the world economy. Central and eastern Europe will continue to perform significantly better than the euro area. Economic growth will weaken somewhat in the CIS, but average rates will remain well above the European average.

A moderate rate of recovery in the euro area

23. For the euro area, real GDP is forecast to increase on average by 1.8 per cent in 2005 (see below, table 1.1.1). For western Europe as a whole, the growth rate will be marginally higher at 2 per cent, reflecting the slightly stronger growth momentum in countries outside the euro area. Those growth rates for 2005 are slightly lower than in 2004, partly because of a smaller number of working days. Positive growth in the rest of the world will continue to support exports, which remain the mainstay of growth. For the recovery to accelerate, domestic demand would have to pick up more strongly than is currently expected. Among three major euro area economies, economic growth will remain sluggish in Germany and Italy in 2005; in France, real GDP is forecast to increase by some 2 per cent. Outside the euro area, in the United Kingdom, the average annual rate of economic expansion is expected to slow down to 2.5 per cent. The stance of fiscal policy is expected to be broadly neutral (possibly even slightly restrictive) for the euro area and western Europe in aggregate in 2005. In view of the fragility of factors of domestic growth and the dampening effects of the stronger euro on domestic economic activity and inflation, monetary policy in the euro area is likely to continue to "wait and see". The European Central Bank is expected to leave interest rates unchanged in 2005,

but there is scope for countering any weakening of the recovery by lowering interest rates, particularly as the stronger euro will dampen imported inflation.

Economic growth should remain strong in central and eastern Europe and the CIS

24. Although GDP growth has started to decelerate in the EU-8 countries, recent economic indicators suggest a favourable short-term outlook. In 2005, the average rate of growth in the EU-8 may slow down somewhat compared with 2004 but, at some 4.5 per cent, will remain considerably above the average of western Europe. A noticeable surge in greenfield foreign direct investment projects should accelerate the ongoing process of restructuring and boost exports. Further fiscal consolidation is envisaged in some countries in 2005 but its dampening effect on domestic demand should be marginal. Most of the south-eastern European economies are also set to maintain strong rates of growth in 2005 but the unusually high rates in some countries in 2004 will be difficult to sustain. Overall, domestic demand is set to remain buoyant, and should provide solid support to economic activity in those countries. Better financial intermediation and rapid credit expansion will continue to fuel output growth throughout central and eastern Europe. However, despite the relatively strong rates of output growth in 2005 the increases in employment are likely to be small.

25. Economic activity in the CIS as a whole may lose some steam in 2005, but aggregate GDP is nevertheless expected to expand by some 6.5 per cent. Decelerating growth rates will prevail in all the large CIS economies — Belarus, Kazakhstan, Russia and Ukraine — following the evolution of external factors such as commodity prices and demand in the region's main markets. Domestic demand in the CIS should generally remain buoyant but its effect on domestic economic activity will depend on the responsiveness of domestic supply. The macroeconomic policy stance should remain broadly neutral in the large economies, with the possible exception of Ukraine, where some fiscal tightening can be expected. While in the short run there may be some further improvement in the labour markets, many CIS economies still have to address the challenge of restructuring as labour adjustment has in general been lagging behind that in output.

Downside risks are dominating

26. The baseline short-term outlook is relatively favourable for the global economy, although that masks disappointingly weak growth in the euro area. But the outlook is surrounded by risks, which continue to be predominantly on the downside. A major uncertainty is the likely development of the international oil markets. Another potential important downside risk for the global economy is the large and rising current-account deficit of the United States. The fact that the global economy continues to rely so much on the United States as a major engine of growth evidently makes the outlook all the more vulnerable to a more pronounced slowdown of the United States economy than anticipated in current forecasts. Moreover, the necessary correction of the large domestic and external imbalances that have developed in the United States economy will hardly be possible without a more or less pronounced slowdown of domestic demand and output growth.

27. Long-term interest rates in international capital markets have, furthermore, remained at unusually low levels in the recovery so far, reflecting, inter alia, the

persistence of moderate inflationary expectations, a weak supply of corporate bonds (a reflection of balance sheet consolidation) and the massive purchase of United States treasury bills by Asian central banks. A stronger than expected rise in long-term interest rates could be caused by the fading of those factors but also by increasing concerns in financial markets about the persistently large United States fiscal deficit, with a consequent dampening effect on economic growth.

28. In western Europe, given its current strong reliance on export growth, the recovery is very vulnerable to a more pronounced weakening of global growth than is currently forecast. A further sharp appreciation of the euro could considerably dampen growth prospects with even the risk of economic growth stalling in 2005. In some countries (France, Ireland, Spain, United Kingdom), the downside risks also include a possible sudden and pronounced reversal of the rise in house prices, with consequent negative wealth effects and, in turn, severe repercussions on private household consumption and the overall rate of economic growth. A potential upside risk is that business investment may respond more favourably than anticipated to the continuation of favourable financing conditions and improved profitability. But the probability of the latter occurring is not very high given the expected deceleration in economic growth.

29. The main external risks to the outlook for central and eastern Europe include a possible sharp deceleration of economic growth in the euro zone and significantly higher than expected energy prices. If imported inflation continues to rise, that may prompt a more restrictive policy stance, with negative implications for economic activity. A number of economies in the region still face important macroeconomic policy challenges, such as large fiscal and current-account deficits. Forthcoming elections in several countries carry the risk of pre-election increases in public spending, which could undermine policy credibility and probably result in monetary tightening, lower inflows of foreign direct investment and reduced competitiveness. The most pressing policy challenges facing the new EU member States are to achieve sustainable fiscal consolidation and implement structural reforms for job-rich growth.

30. The main structural weakness of the CIS economies remains their high dependence on exports of natural resources and low value-added products, implying a high degree of vulnerability to external shocks. In addition, there are already signs, especially in Russia, that the loss of competitiveness associated with real exchange rate appreciation (the "Dutch Disease") is becoming a burden on local producers and is choking off aggregate domestic economic activity. The capacity of macroeconomic policy to address those negative developments is fairly limited. Unless local producers manage to counteract them at the micro level through further restructuring, there are likely to be negative repercussions on output growth in the affected countries, especially in their manufacturing industries. The long-term growth prospects of the CIS economies thus hinge on their success in diversifying their economies and implementing key reforms in product and financial markets.

III. Selected policy issues

A. Finding the balance: structural reforms and the macroeconomic policy framework in Europe

31. In Europe, the short-term prospects for weak domestic demand growth being offset by a strengthening of exports to the rest of the world do not look very favourable. The recovery in the European economy virtually came to a halt in the third quarter of 2004 and current forecasts are for only a moderate rise in economic activity in 2005.

32. The main policy challenge is to bridge the gap between the rhetoric of the ambitious Lisbon agenda, which aims at creating a competitive and dynamic economy at par with the United States, and the disappointing reality of progress falling significantly short of the intermediate targets. A major problem with the Lisbon agenda is its almost exclusive focus on supply-side reforms as a basis for creating a dynamic economy that combines both strong employment and productivity growth. But market outcomes are not determined solely by supply but by the interaction of the forces of supply and demand. It will be difficult to meet the targets of the Lisbon agenda in a context of weak growth of domestic demand.

33. Sustaining higher rates of growth is also a *conditio sine qua non* for preserving the European model, with its strong concern for social cohesion. The adjustment pressures arising from the intensification of international competitive pressures, rapid rates of technical change (with a clear bias against low-skilled labour), as well as population ageing, all make that challenge even more difficult.

34. A recent report on the Lisbon strategy, the so-called Kok report, has concluded that the agenda is far too broad and has partly conflicting objectives. It therefore proposed that the strategy should focus on five, although still quite broad, priority areas where progress is to be pursued within the framework of national action programmes. The areas are the formation of a knowledge society with a strong emphasis on innovation and research; the completion of the internal market, which requires a closer integration of services markets and network industries; the fostering of a more conducive business climate, inter alia, by facilitating market entry and the development of venture capital markets; further reforms of labour markets designed to improve intra-EU labour mobility; and the promotion of environmental sustainability.

35. Raising Europe's growth potential, however, requires not only supply-side reforms but also a sufficiently flexible macroeconomic policy framework (i.e., mainly monetary and fiscal policy) that is "as supportive of growth as possible" (Kok report) while paying adequate attention to preserving macroeconomic stability. In a similar vein, the Sapir report has emphasized the need for combining microeconomic reforms with a revision of the Economic and Monetary Union's macroeconomic policy framework, taking especially into account the increased heterogeneity of the EU after enlargement, which calls for more flexible rules to limit the potentially adverse implications of "one-size-fits-all" policies. The challenge is to find the proper balance between discipline and flexibility.

36. A sensible reform of the Stability and Growth Pact, combined with realistic and firm objectives for medium-term fiscal consolidation, could also create a new basis for a kind of European "policy mix", that is, for cooperation between the

European Central Bank and the European Council (or the so-called euro group). Monetary policy should be symmetric over the business cycle, giving equal weight to upside and downside risks to both price stability and economic growth. That becomes even more important given the general orientation of fiscal policy towards ambitious consolidation targets, which will be achieved much more easily in a context of sustained economic growth.

B. The policy challenge of economic diversification in the CIS

37. While rates of GDP growth in most CIS economies have been impressive in recent years, there are nevertheless concerns about their sustainability. The key factor behind the economic boom in the resource-rich CIS economies has been the expansion of their extractive industries (especially, the crude oil and natural gas sectors) coupled with a surge in world commodity prices in the last few years. The narrow base of the recovery exposes those economies to fluctuations in the highly volatile global commodity markets, making them vulnerable to external shocks. Besides, mineral extraction is a capital-intensive activity generating little employment and is likely to result in geographically unbalanced development and greater income inequality.

38. The key policy issue is whether and how public policy can help to broaden the growth base and reduce the excessive reliance on natural resources in the medium and longer term. The recent policy debate in some CIS economies has focused on the need for economic diversification as a key factor of economic development as well as the basis of high and sustainable rates of growth. Despite the differences in national circumstances, diversification has figured prominently in the development strategies recently elaborated in some countries. However, there is still much ambiguity with regard to the ways and means to achieve that objective.

39. The disintegration of the CMEA and then of the Soviet Union triggered a collapse of much of the manufacturing industry in the CIS. As a result, the production and export structures in most CIS economies have become more specialized and concentrated, especially in the resource-rich economies. For example, in Russia the share of the top five export products in total exports increased from 62 per cent in 1996 to 68 per cent in 2003 (four of those five products were primary commodities and fuels) and the share of the top 10 products increased from 72 per cent to 77 per cent. A similar process of concentration towards commodity exports is observable in many CIS economies. Such a narrow specialization pattern may be counterproductive for a balanced development path, especially for the low-income CIS countries.

40. Economic diversification has, of course, different aspects and dimensions across the CIS countries. There is a clear distinction between economies with abundant resources of crude oil and natural gas, and the less richly endowed countries, where the increased shares of commodity exports mostly reflect the outcomes of post-Soviet deindustrialization. At the same time, resource-rich economies face specific problems that may even risk becoming impediments to their economic development.

41. While natural resource abundance can in principle be an important source of development finance, the relationship between natural resource endowments and economic performance cannot be considered as deterministic. In fact, past

experience provides ample evidence of a negative relationship, sometimes referred to as the "resource curse". The channels through which the "resource curse" can emerge and escalate include, inter alia, a weak institutional environment and poor public governance (notably, resource riches tend to be associated with higher degrees of corruption and rent-seeking activities). The real exchange rate appreciation associated with large and rising exports of natural resources can become an impediment to other economic activities (the so-called Dutch Disease). Another problem is the general economic volatility and vulnerability of the economy to external shocks. However, there have also been a number of cases where natural resources have served as a basis for successful economic diversification and development of a country. Prudent financial management and an appropriate institutional environment (Norway being a good example) can prevent or minimize the potential negative side effects. Whether a resource-rich country falls into the trap of the "resource curse" or manages to use the resource endowment to jump-start economic diversification largely depends on the country-specific institutional context and the policy framework designed to foster economic development. In any case, a carefully designed, and duly implemented, policy agenda can greatly reduce the risks of the "resource curse" in the resource-rich CIS countries and can facilitate the process of their economic diversification.

42. The policy challenge of economic diversification is even more daunting in the CIS countries that are not so rich in natural resources. They are also the countries with lower levels of per capita income and a higher incidence of poverty. While policymakers in those economies face some basic development problems, they do not have at their disposal the financial cushion created by resource windfalls. Nevertheless, the main principles of addressing the goal of economic diversification should be broadly similar across the CIS.

43. The economic argument underlying diversification policies is that a comparative advantage in the international division of labour should not be regarded as something given once and for all. Comparative advantage (as revealed in the structure of net exports) changes over time as a result of shifts in the pattern of physical and human capital accumulation. But new areas of comparative advantage will be cultivated only if properly developed by venturing entrepreneurs. The CIS economies are by no means doomed to be locked into their current, highly skewed production and export structures; they need, however, to undertake a dedicated long-term effort to cultivate their potential and develop new areas of comparative advantage.

44. The potential existence of comparative advantage (of the type discussed above) that is not cultivated under market conditions may be regarded as a case of market failure. Both economic theory and experience indicate that one of the efficient ways to deal with that type of market failure is through appropriate policy intervention. In a global perspective, successful industrialization or economic diversification (including western European industrialization in the nineteenth century but also the post-war rise of the south-east Asian economies and, more recently, the experience of Ireland), has almost always been driven by an active government policy stance. However, experience has also shown that while markets alone may not be sufficient to steer economic restructuring, Governments alone cannot deliver satisfactory results either, as illustrated by the disastrous welfare outcome of central planning (of which the CIS economies still bear the cost). Also, some traditional approaches to industrial policy (such as "picking winners", or

import substitution policies) are notorious for negative side effects such as market distortions, inefficient resource allocation and corruption.

45. In the absence of well-functioning markets, there may be other factors impeding the cultivation of potential comparative advantage (for example, poor protection of property rights, weak contract enforcement, etc.). That argument applies to many of the CIS economies, especially those that are less advanced in their economic transformation. The establishment of well-functioning markets is thus not only a necessary condition for the successful implementation of diversification policies but can be expected to provide a further boost to that process.

46. Based on the experiences of other countries, the broad paradigm of a policy framework targeting economic diversification in the CIS economies should incorporate key ingredients such as:

- A coherent long-term strategy outlining the main goals to be achieved. Importantly, the formulation of long-term goals should involve a broad public debate. It is essential that the strategy reflect national goals that enjoy broad public support and popular legitimacy and will not be subject to revisions over the political cycles
- An incentive structure that will stimulate economic agents to act in a direction consistent with the policy goals as well as the mechanisms of coordination and management of conflicting interests (for example, between the public and private sectors). Incentives should include both "carrots" (motivating agents to undertake specific actions) and "sticks" (including early identification of failure and exit strategies)
- An appropriate framework of public institutions with delegated authority to implement the related policies. Clear rules of practical implementation of policy conventions coupled with transparency and accountability in the operation of those institutions are essential to avoid the capture of policy by vested interests and to prevent corrupt practices
- Adequate funding. Policy actions targeting diversification inevitably involve public funding. Resource-rich economies can in principle draw on the rents associated with natural resources to fund the strategies targeting new areas of comparative advantage. When natural wealth is not abundant, the channelling of public funds towards diversification policies should not endanger long-term fiscal sustainability.

47. There is no unique policy model of economic diversification (and for that matter, no unique diversification pattern); success (as well as failure) can take many different forms, and that applies with full force to the related policy agenda in the CIS. But experience of other countries unambiguously suggests that the adequacy and quality of the institutional arrangement is probably the key factor of success in implementing diversification policies. In other words, the normative policy rules and objectives must be matched by an appropriate institutional framework in the broader sense of formal and informal "rules of the game". Many negative side effects of industrial policy in the traditional sense can be directly linked to the deficiency or inadequacy of the institutional framework within which it was being implemented. In that regard, the establishment of adequate institutions should be regarded as part and parcel of the diversification strategy. Strong and dependable

institutions are also required for high rates of GDP growth to be sustained in the context of adverse shocks. The actual institutional changes will depend on the specific socio-economic and political context in the country where such a strategy is being implemented.

48. In countries that are still undergoing a profound economic transformation, such as the CIS economies, the policy challenges of economic diversification are compounded by the unfinished systemic and structural reforms required to establish a fully functioning market economy. At the same time, the existing gaps in some areas of market development can also be regarded as an opportunity for policymakers. Indeed, it may be easier to establish a new, well-functioning institution starting from scratch (provided it is well designed and properly assembled) than by trying to change or amend an already existing (but malfunctioning) institution.

49. Recent experience suggests that the most effective institutional arrangements targeting economic diversification are those that engage all the relevant stakeholders (both from the public and from the private sector) in the process of policy design and in its implementation, and steer them towards the common goal. Instead of "picking winners" in the sense of traditional industrial policy, that approach involves a more flexible strategic alliance (that can be of a long-term nature) in which the Government and the private sector exchange information and ideas, and coordinate their actions in the development of new activities, products or technologies. Through strategic collaboration between the parties involved, that policy model seeks to identify the causes of market failures that result in the underprovision of entrepreneurship in the pursuit of economic restructuring. If properly designed and instituted, the rules of interaction, the shared commitments and responsibilities, the transparency in operation and accountability in the use of public funds within such alliances should help to minimize the market distortions and corrupt practices that sometimes taint conventional industrial policy.

50. Obviously, the appropriate institutional framework is only one component of the broad policy agenda targeting economic diversification and development in the CIS economies. Overall, reform initiatives should focus on those areas that have a general impact on the cost of economic activities, including basic infrastructures, where public investment plays a central role. In that context, as the private sector becomes the means of achieving public goals, public policy should foster private sector development and entrepreneurship by reducing the cost of doing business and establishing a conducive environment for the attraction of both domestic and foreign investment. Further efforts are also needed to improve public and corporate governance and eliminate the existing numerous market imperfections.

51. The broader policy agenda should also target innovation and human capital development, which are key factors of long-term growth and competitiveness. In fact, many of the CIS countries (in particular Russia and other larger economies) are better placed to pursue an innovation-driven diversification agenda than some of the resource-rich developing countries due to their already existing human capital endowment. But policy should also seek to eliminate existing structural rigidities that may hamper the transformation of human capital endowments into innovative entrepreneurial activity.

52. The development of the financial system is of particular importance in fostering productive investment and hence diversification. Facilitating credit access

would ease a key constraint on the development of new economic activities and the promotion of innovation. A well-functioning banking system in resource-rich economies is also required to efficiently channel the surpluses generated in fast-growing, commodity-based activities to investment opportunities in other sectors.

53. Wider regional economic cooperation and further integration into the global economy can also serve to foster economic diversification by increasing the effective size of the market and encouraging foreign direct investment outside the resource sectors. That is particularly relevant for the smaller CIS economies, where the role of external demand for economic development is more obvious and for many landlocked countries where transit issues are more painfully felt. But as a word of caution, trade liberalization alone may not necessarily stimulate new economic activities (as evidenced by recent experience); for those to materialize, the integration efforts should complement domestic policies fostering diversification. In addition, it is crucial that trade and transit arrangements that increase market access are perceived as stable and not subject to possible reversals if those beneficial effects are to be obtained.

54. In addition, diversification policies require specific skills from the government agencies that will be involved in implementation. A public administration with adequate capacity is in fact a precondition for engaging in any large-scale government-sponsored programmes. Capacity-building efforts thus emerge as an important policy step that should be assigned high priority, especially in the lower-income CIS countries. Obviously, that is also an area where targeted assistance by the international community (which will not necessarily require large-scale funding) can generate high returns in terms of its welfare effect in the recipient countries.

55. Economic diversification in the CIS region should be regarded as a long-term policy goal. Given the economic structures that currently prevail, dependence on commodity exports is likely to remain a dominant feature of many CIS economies for some time to come. Successful economic diversification requires an integrated and consistent policy framework that relies on comprehensive reforms in many areas and calls for a lasting and dedicated policy effort.

C. Financial vulnerability in the ECE emerging market economies

56. The level of net capital inflows and the corresponding current-account deficits of the majority of the ECE emerging market economies have been relatively large for the last decade. That has allowed investment and consumption to be maintained at levels above those that would have been possible in their absence. Growth can be increased with external finance since the level of domestic investment is no longer constrained by domestic savings. Those capital inflows have allowed the emerging market economies to partially rebuild the productive capital stocks that were inadequate for a market economy. In addition, that inflow allowed consumption levels to be partially maintained despite the collapse in economic activity during the transition phase. Although those advantages are very important, the emerging market economies should remain cognizant of a number of additional constraints and qualifications that apply to a development strategy based upon a strong reliance on external finance. Those primarily include more stringent constraints on macroeconomic policy, the opportunity cost of holding increased amounts of international reserves, and the loss of national income during a currency crisis if one

should occur. Owing to those constraints, the benefits of capital market openness may well be smaller for emerging markets than for more advanced economies.

57. Given the significant levels of capital inflows into the emerging market economies, there is the possibility that for some of those economies capital account liberalization may have proceeded too rapidly given their domestic institutional reforms. Since boom-bust cycles seem to characterize emerging market economies throughout the world, especially given the current international financial architecture, additional prudence towards adjusting both current-account and fiscal deficits to sustainable levels during this period of relatively favourable performance would be in order.

58. It is difficult to assess the degree to which the emerging market economies current-account deficits are likely to be problematic for economic stability. Almost all analyses of previous exchange rate crises have concluded that large or increasing current-account deficits were a significant contributing factor. However, the risk posed by a current-account deficit cannot be evaluated solely by its size; it will also depend on how it is being financed, how it is being used, the exchange rate regime, current debt levels, the size of international reserves, the health of the financial system and the country's overall macroeconomic condition. Although there has been some progress in understanding the factors that may eventually trigger a currency crisis, there remain significant gaps in knowledge, and each crisis appears to be somewhat different from previous ones. The fundamental problem is that current-account deficits that appear sustainable under current conditions may no longer be viewed as such after some unforeseen, and perhaps totally external, shock. The question of sustainability is often raised for countries with current-account deficits significantly above their GDP growth rates. That is especially the case for those countries with double-digit current-account deficits and high levels of external debt relative to official reserves or GDP. Most of the emerging market economies have maintained current-account deficits below 10 per cent of GDP, the level of Mexico's deficit in the years prior to its financial crisis in 1994. However, many have deficits that are larger than several of the East Asian countries prior to their financial crises in 1997-1998. Given that the region has limited experience with open capital accounts and a susceptibility to currency crises, including Bulgaria in 1996, the Czech Republic and Romania in 1997, Russia in 1998, Turkey in 2000-2001, and several speculative attacks against Hungary in 2003, concern about possible future currency instability would seem to be warranted. Attention towards current-account deficits and possible financing difficulties needs to be heightened during periods, such as the current one, when global liquidity is being tightened.

D. Upcoming challenges from globalization

59. In order to reap the benefits of international trade integration, just as with financial integration, it is necessary to have in place the necessary complementary domestic institutions and policies. The failure to do so can be just as costly although not as dramatic as a currency crisis resulting from an institutional failure under financial integration. In the case of trade integration, the result can be increased unemployment, lower investment and increased inequality. The traditional benefits of increased specialization from trade openness can be easily negated if the displaced workers become unemployed, and the benefits of higher national income can be lost if it is more unequally distributed.

60. Each of the emerging market economies subregions will need to find a niche for themselves in the global production system. The EU-10 should be able to find a place in the manufacturing chain given their open access to the EU market, their relatively high levels of human capital but considerably lower wages. Market fragmentation and limited institutional reform are continuing to limit manufacturing in some of the south-east European countries. Currently, the CIS economies appear to be largely outside the global manufacturing network; that is due to both the devastation of their manufacturing sectors during the transition phase and their natural competitive advantage in natural resource products. However, those primary commodities will not provide the countries with the basis to become dynamic growth economies.

61. Over the last half-century, countries in the middle of the global income distribution, which were also integrating into the world trading system, had relatively good growth rates and were able to converge towards the per capita income levels of the richer countries. If that historical pattern were to hold in the coming decades, most of the emerging market economies, which clearly fit into that middle zone, would be expected to do relatively well. However, over the last half-century, those industrializing middle-income countries were not under a significant competitive threat from industrializing countries with even lower per capita incomes. In the coming decades, however, the emerging market economies will have to compete with countries such as Brazil, China and India; those countries have not only much lower wages but are in many areas as advanced or even more advanced technologically than the emerging market economies. There are of course some high-tech niche markets in the emerging market economies, but they are not sufficient to employ large numbers of people. Thus, the challenge will be to determine the sectors in which they will have a comparative advantage and also the potential for technological growth along with high and increasing wages. To avoid the undesirable situation of having to compete on the basis of low wages, the emerging market economies would appear to have little choice but to create knowledge-based societies by increasing investment in human capital formation and implementing policies to promote more entrepreneurship and innovation.

Table 1.1.1

Annual changes in real GDP in Europe, North America and Japan, 2002-2005

(Percentage change over the previous year)

	2002	2003	2004[a]	2005[a]
France	1.2	0.5	2.2	1.9
Germany	0.1	-0.1	1.7	1.3
Italy	0.4	0.3	1.2	1.6
Austria	1.2	0.8	1.8	2.3
Belgium	0.9	1.3	2.6	2.4
Finland	2.3	1.9	2.9	2.9
Greece	3.6	4.5	3.8	2.7
Ireland	6.1	3.7	4.3	4.6
Luxembourg	2.5	2.9	4.0	3.5
Netherlands	0.6	-0.9	1.2	1.6
Portugal	0.4	-1.2	1.2	1.9
Spain	2.2	2.5	2.6	2.5

	2002	2003	2004[a]	2005[a]
Euro area	0.9	0.6	1.9	1.8
United Kingdom	1.8	2.2	3.2	2.5
Denmark	1.0	0.5	2.2	2.3
Sweden	2.0	1.5	3.4	2.9
EU-15	1.1	0.9	2.2	2.0
Cyprus	2.1	1.9	3.2	3.6
Czech Republic	1.5	3.7	3.8	3.9
Estonia	7.2	5.1	5.9	5.6
Hungary	3.5	3.0	3.8	3.8
Latvia	6.4	7.5	7.0	6.0
Lithuania	6.8	9.7	6.7	5.8
Malta	2.6	-0.3	1.0	1.5
Poland	1.4	3.8	5.7	4.9
Slovakia	4.6	4.5	5.1	5.0
Slovenia	3.3	2.5	3.8	3.9
New EU members-10	2.4	4.0	4.9	4.5
EU-25	1.2	1.1	2.4	2.2
Iceland	-0.5	4.0	4.3	4.7
Israel	-0.7	1.3	3.5	3.7
Norway	1.4	0.4	3.4	2.9
Switzerland	0.3	-0.4	1.8	1.7
WECEE	1.2	1.1	2.4	2.2
Canada	3.4	2.0	2.7	3.0
United States	1.9	3.0	4.4	3.5
North America	2.0	3.0	4.3	3.5
Japan	-0.3	1.3	3.9	1.5
Europe, North America and Japan	1.3	1.9	3.4	2.7
Memorandum items:				
EU-8	2.4	4.0	5.0	4.6
Western Europe-20	1.1	0.9	2.2	2.0
Western Europe and North America	1.6	2.0	3.3	2.8

Source: Eurostat; OECD national accounts and national statistics; ECE secretariat estimates; Consensus Economics, *Consensus Forecasts*, 6 December 2004 and *Eastern Europe Consensus Forecasts*, 15 November 2004.

Note: All aggregates exclude Israel. WECEE (Western Europe, central and eastern Europe) comprises the EU-25 plus Iceland, Norway and Switzerland. EU-8 (central Europe and the Baltic States) includes the new EU members less Cyprus and Malta. Western Europe-20 comprises the EU-15 plus Cyprus, Iceland, Malta, Norway and Switzerland. For data on south-east European and European CIS countries, see table 1.1.2.

[a] Forecasts.

Table 1.1.2
Annual changes in real GDP in south-east Europe and the CIS, 2002-2005
(Percentage change over the previous year)

	2002	2003	2004[a]	2005[a]
South-east Europe	6.5	5.1	7.9	5.2
Albania	3.4	6.0	6.0	6.0
Bosnia and Herzegovina	3.7	3.2	4.0	4.3
Bulgaria	4.9	4.3	5.5	5.3
Croatia	5.2	4.3	4.0	4.4
Romania	5.0	4.9	7.5	5.2
Serbia and Montenegro[b]	3.8	1.5	7.0	4.5
The former Yugoslav Republic of Macedonia	0.9	3.4	2.5	3.5
Turkey	7.9	5.8	9.0	5.3
CIS	5.2	7.7	7.9	6.4
Armenia	15.1	13.9	10.0	8.0
Azerbaijan	10.6	11.2	9.5	14.0
Belarus	5.0	6.8	10.0	9.0
Georgia	5.5	11.1	6.0	5.0
Kazakhstan	9.8	9.3	9.3	7.9
Kyrgyzstan	0.0	6.7	6.5	7.0
Republic of Moldova[c]	7.8	6.3	8.0	6.0
Russian Federation	4.7	7.3	6.8	5.8
Tajikistan	9.5	10.2	11.0	8.3
Turkmenistan[d]	1.8	6.8	6.0	7.0
Ukraine	5.2	9.4	12.4	6.5
Uzbekistan	4.2	4.4	7.6	6.4
Total above	5.6	6.9	7.9	6.0
Memorandum items:				
South-east Europe without Turkey	4.6	4.2	6.4	5.0
CIS without Russian Federation	6.2	8.5	10.1	7.5
Caucasian CIS countries	9.9	11.7	8.6	10.0
Central Asian CIS countries	6.6	7.5	8.4	7.3
Three European CIS countries	5.3	8.6	11.6	7.2
Low-income CIS economies	6.3	7.7	8.1	7.9

Source: National statistics, CIS Statistical Committee; reports by official forecasting agencies.
Note: The aggregation was performed using weights based on purchasing power parities. Aggregates shown are: south-east Europe (the 8 countries below that line); CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates are: Caucasian CIS countries: Armenia, Azerbaijan, Georgia; central Asian CIS countries: Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries: Belarus, Republic of Moldova, Ukraine; low-income CIS economies: Armenia, Azerbaijan, Georgia, Republic of Moldova, Kyrgyzstan, Tajikistan and Uzbekistan. Unless otherwise noted, country forecasts shown are those reported by official forecasting agencies.
[a] Forecasts.
[b] Excluding Kosovo and Metohija.
[c] Excluding Transdniestria.
[d] UNECE secretariat estimates.

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Overview of the Economic report on Africa 2005: "Meeting the Challenges of Unemployment and Poverty in Africa"**

Summary

The present report is based on the Economic report on Africa 2005, which indicates that Africa's gross domestic product (GDP) grew by 4.6 per cent in 2004, the highest rate in almost a decade, up from 4.3 per cent in 2003. Higher prices of commodities, including oil, good macroeconomic management, better performance in agriculture and the improved political situation in many countries, along with increased donor support in the form of aid and debt relief, contributed to this positive outcome. However, given the importance of the European Union as a trading partner with Africa, the relatively slow growth in the European Union may have retarded the overall growth performance in the continent.

Official Development Assistance (ODA) to Africa recovered from a low of $15.7 billion United States dollars to a new high of $26.3 billion in 2003. This recovery was largely driven by debt relief provided through the Heavily Indebted Poor Country Initiative (HIPC) and emergency assistance. The Development Assistance Committee of the Organization for Economic Cooperation and Development accounts not only for the bulk of ODA as a whole, but also a significant share of ODA to Africa in particular. Foreign Direct Investment (FDI) flows increased from $12 billion to $15 billion in 2003 and were projected to rise to $20 billion in 2004. FDI flows, however, tended to be concentrated regionally, that is, in North Africa and sectorally, that is, in extractive industries.

* E/2005/100.

** For presentation at the Conference of Ministers, 2005: derived from the Economic report on Africa 2005, "Meeting the Challenges of Unemployment and Poverty in Africa".

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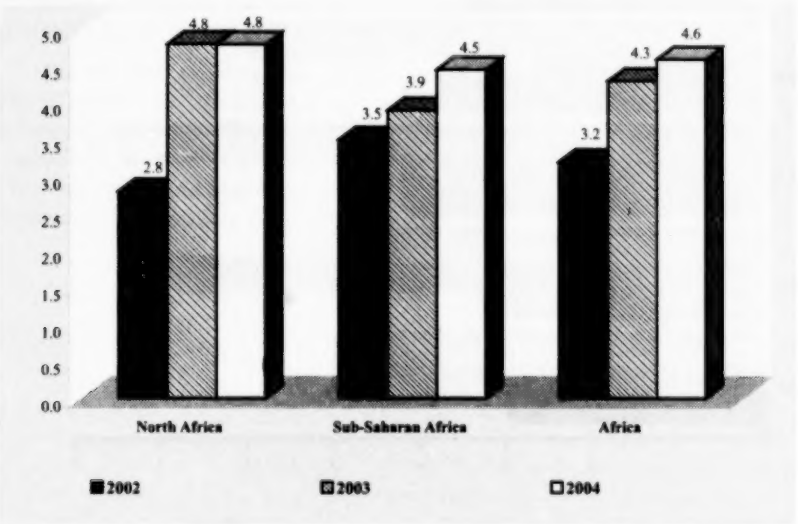
Notwithstanding the favourable growth performance of Africa in 2004 and its projected growth of 5 per cent in 2005, savings and investment remain low, barely exceeding 20 per cent of GDP during 2000-2002. Any slowdown in the global economy may have adverse implications for Africa. Moreover, its growth will be underpinned by continued macroeconomic stability; rising African exports in the context of slower global growth; continued improvement in agricultural output, assuming continued good weather conditions; and vibrant growth in the tourism and mining sectors.

With respect to achieving the Millennium Development Goals, North Africa is singled out as a subregion showing remarkable progress. Sub-Saharan Africa, despite reflecting a real growth in GDP since 1998, is making slow progress towards meeting the Millennium Development Goals, particularly on halving poverty, reducing maternal mortality and increasing the primary education completion rate. Overall, the majority of countries still lag behind and special efforts will be required to ensure that they can achieve the Goals.

I. Overall growth performance

1. Africa's real gross domestic product (GDP) grew by 4.6 per cent in 2004, the highest in almost a decade, up from 4.3 per cent in 2003 (see figure 1 below). This improvement was underpinned by higher prices of commodities, including oil, stemming from a strong growth in global demand. In addition, good macroeconomic management, better performance in agriculture, the improved political situation in many countries and increased donor support in the form of aid and debt relief contributed to the positive outcome. The favourable growth performance in Africa in 2004 reflects a continued upward trend, evident since 1998. Unfortunately, this trend has thus far not been translated into employment creation or poverty reduction.

Figure 1
Real growth in GDP in Africa, 2002-2004
(Percentage)



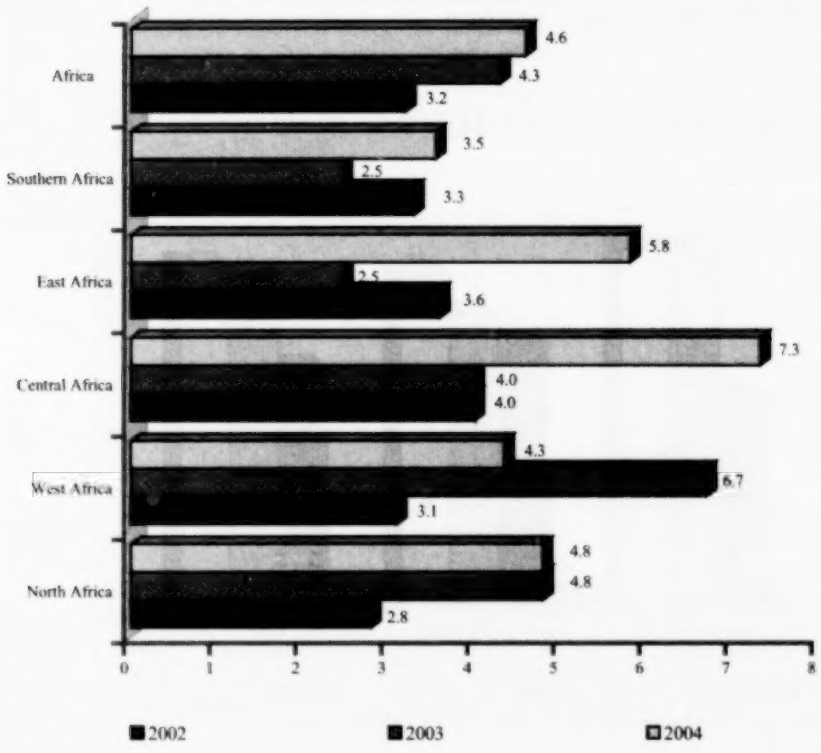
Source: Economic report on Africa 2005 (Economic Commission for Africa).

A. Subregional performance

2. The escalation in economic growth on the African continent between 2003 and 2004 was attributable to an improvement in the performance of sub-Saharan Africa, in contrast with 2002 and 2003 when the increase was centred in North Africa (see figure 1 above).

3. Central Africa experienced the highest growth rate in 2004, followed by East Africa, North Africa, West Africa and Southern Africa (see figure 2 below). Between 2003 and 2004, only West Africa experienced a reduction in its growth rate, from nearly 7 to about 4 per cent.

Figure 2
Real growth in GDP at the subregional level in Africa, 2002-2004
(Percentage)



Source: Economic report on Africa 2005 (Economic Commission for Africa).

4. Contributing to the relatively slow growth rate in West Africa was the decline in real growth in GDP in Nigeria, from 10.2 per cent in 2003 to 4.6 per cent in 2004.[1]

5. Contributing to the weak performance in West Africa was the ongoing political crisis in Côte d'Ivoire, which led to yet another year of slow growth in real GDP (0.9 per cent in 2004). Furthermore, a locust invasion seriously affected the agricultural sectors of Mali, Niger and Senegal, contributing to their relatively low growth rates.

6. On the other hand, growth in six of the 15 West African countries was 5 per cent or higher, with Liberia leading the group with a real growth rate of 15 per cent,

followed by the Gambia (6.6 per cent), Sierra Leone (6.6 per cent), Burkina Faso (5.4 per cent), Cape Verde (5.4 per cent) and Ghana (5.3 per cent).

7. Rising oil prices buoyed growth in North and Central Africa. Meanwhile, East and West Africa benefited from increased agricultural production coupled with rising commodity prices. In Southern Africa, real growth in GDP increased in 2004, mainly as a result of steady growth in South Africa, which benefited from strong global and domestic demand created, in part, by its low interest rate environment.

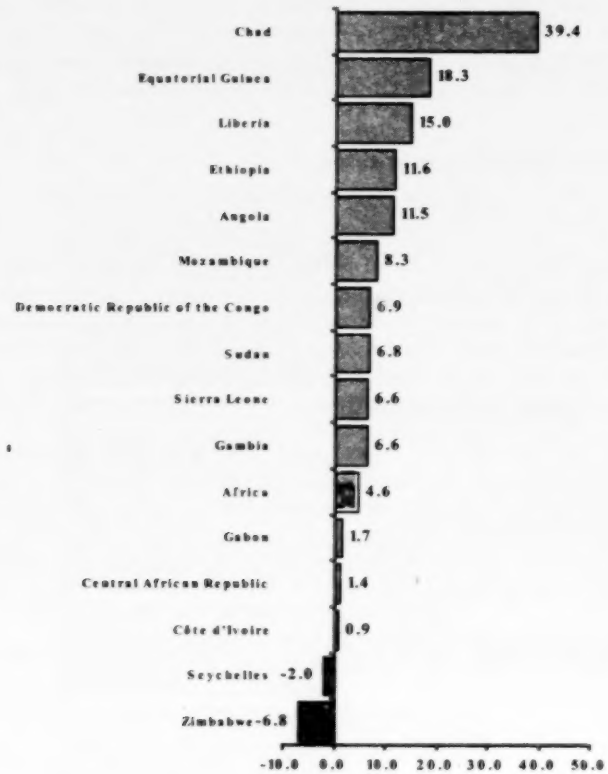
B. Fastest versus slowest growing countries

1. 2004 growth record

8. The fastest growing African countries in 2004 were Chad, Equatorial Guinea, Liberia, Ethiopia, Angola and Mozambique (see figure 3 below). Liberia's strong performance must be placed in context. As a more recent post-conflict economy, Liberia grew from a relatively low base of output. In addition, its growth was buoyed by substantial external aid in support of its rebuilding efforts. Thus, the sustainable nature of the growth may be in question.[2]

9. The slowest growing economies in Africa were Zimbabwe, the Seychelles, Côte d'Ivoire, the Central African Republic and Gabon (see figure 3 below). Performance was hampered by drought and an adverse political environment (Zimbabwe); continuing political turmoil (Côte d'Ivoire); and, despite the discovery of new oil fields and higher oil prices, a decline in oil production owing to limited investments in upgrading existing fields (Gabon).[3]

Figure 3
Top ten and bottom five performers in Africa, 2004
(Percentage)



Source: Economic report on Africa 2005 (Economic Commission for Africa).

2. Half-decadal growth record

10. To measure whether the growth performance for 2004 was representative of medium-term performance, table 1 below presents data on the fastest and slowest growing countries based on real GDP growth rates for the period from 2000 to 2004.

11. Seven of the top 10 performing countries in Africa in 2004 maintained average growth rates of 5 per cent or more during the period from 2000 to 2004 (see table 1 below). Equatorial Guinea and Chad maintained double-digit growth rates, while Mozambique, Angola and the Sudan had growth rates of better than 6 per cent over the same period. Of the top 10 performers in 2004, the only countries that failed to maintain average growth rates of 5 per cent or better were the Democratic Republic of the Congo, Sierra Leone and the Gambia. This outcome reflects the post-conflict situations, in particular in the Democratic Republic of the Congo and Sierra Leone.

12. Interestingly, the slowest growing countries in 2004 also experienced the lowest growth rates during 2000-2004. The countries are Zimbabwe, the Seychelles, Côte d'Ivoire and the Central African Republic.

13. The implication is that the growth performance of the top and bottom performers has been fairly stable over the last half-decade. Overall, 14 African countries have been capable of sustaining their growth at 5 per cent or higher since 1999, a rate that puts them closer to meeting the estimated 7 per cent rate required to achieve Millennium Development Goal number 1, on poverty reduction.[4] The current finding also suggests that more in-depth country-specific studies are required in order to explore the variance of performance across countries.

Table 1
High and low growth African countries: 2000-2004
(Percentage)

High growth countries[a]	*Average growth 2000-2004*	*Low growth countries*[b]	*Average growth 2000-2004*
Equatorial Guinea	26.0	Somalia	1.8
Chad	14.9	Comoros	1.7
Mozambique	9.7	Malawi	1.6
Angola	8.0	Kenya	1.6
Sudan	6.8	Gabon	1.4
Ethiopia	5.6	Guinea-Bissau	1.3
Rwanda	5.5	Central African Republic	1.3
Liberia	5.3	Côte d'Ivoire	0.2
Uganda	5.3	Seychelles	-0.1
Burkina Faso	5.3	Zimbabwe	-7.5
Mauritius	5.2		
Senegal	5.2		
United Republic of Tanzania	5.0		
Botswana	5.0		

Source: Economic report on Africa 2005 (Economic Commission for Africa).
[a] Countries with 5 per cent or more average growth (2000-2004).
[b] Countries with less than 2 per cent average growth (2000-2004).

II. Internal sources of growth, 2004

14. The internal factors explaining the growth record in Africa in 2004 include: continued macro-stability based on prudent fiscal and monetary policy; an improvement in the current account balance owing to rising commodity prices (including cash-crop agriculture); receipts from tourism; and improved political stability in several African countries.

A. Macro-stability

Declining inflation

15. On average, inflation in Africa declined from 10.3 to 8.4 per cent between 2003 and 2004. This favourable trend was due to prudent monetary and fiscal policies, good harvests and relatively stable and, in some cases, appreciating exchange rates. The average trend, however, masks country differences. While inflation declined in 29 African countries, it increased in 20 others. Double-digit inflation was experienced in 12 African countries, and one country (Zimbabwe) registered triple-digit inflation. In contrast, Chad experienced deflation despite rising energy prices.[5]

Fiscal deficits eased

16. Fiscal deficits in Africa declined between 2003 and 2004; 32 countries recorded either surpluses or declines in their fiscal deficit. Of the 32 countries, 13 recorded surpluses while 19 experienced declines. Fiscal surpluses were concentrated in oil-producing countries; 8 of the 13 countries that experienced a fiscal surplus were oil producers.

17. The success of African economies as a whole in improving their fiscal stance in 2004 was attributable to revenues generated from windfall gains in oil prices and prudent fiscal policies. Notwithstanding progress on the fiscal front, challenges remain for several African countries; 10 countries actually experienced deficits in excess of 5 per cent of GDP.[6]

18. Deficits largely resulted from increased expenditure in order to: ensure food security (Malawi), finance public sector salary arrears (Guinea-Bissau), scale up social spending (Mauritius), fund elections (Malawi and Zimbabwe) and finance the reconstruction of war-torn economies (Sierra Leone and Angola).

B. Current accounts improved

19. Roughly one-half of African countries (26 out of 51) experienced an improvement in their current accounts, which moved from a deficit of 0.1 per cent of GDP to a surplus of 0.4 per cent for the continent overall.

20. The favourable performance in current accounts was due to strong growth in oil- and non-oil exports and improved market access facilitated by initiatives such as the Africa Growth and Opportunities Act and the Everything but Arms Act enacted by the United States Government. The combined value of the exports of the 37 countries eligible under the Africa Growth and Opportunities Act to the United States grew by 38.1 per cent in 2004, up from $24.4 billion in 2003. However, the conditions attached to these preferential trading arrangements, in terms of rules of origin and time-bound preferential treatment, are constraints to export growth. Furthermore, the end of the Multi-Fibre Agreement poses a challenge for African textile and garment producers, since it will open up the market to intense competition, in particular from highly competitive countries such as China, Pakistan and India. In effect, the contribution of textile and garment exports to the current accounts of African economies could be compromised as a result of the rollback of the Multi-Fibre Agreement.

21. Overall, exports grew at 23.5 per cent as a result of both volume (8 per cent) and price increases, pointing to the improvement in the terms of trade. Import growth averaged 16.9 per cent, reflecting higher incomes and rising oil and food prices. Import growth in oil-producing countries was also fuelled by increased investments to expand oil-production capacity. Nonetheless, the majority (8 out of 14) of the countries that experienced a surplus in their current accounts were oil-producing countries.

C. Tourism on the rise

22. Tourism is fast becoming an important source of foreign exchange earnings in Africa. Receipts from the tourism sector were $18.6 billion in 2003 (the latest year for which data is available), representing an increase of 19.2 per cent over 2002. Receipts per tourist arrival were estimated at $510 in 2003. While these amount to only about one-half the per capita tourist expenditure in the Americas ($1,029), they nevertheless represent a significant source of income for African economies. Indeed, together with an enabling environment and delightful weather conditions, the low cost of touring Africa may be a positive factor, making Africa a preferred destination for tourists.

III. External sources of growth, 2004

23. Among the external factors explaining African economic growth in 2004 are: increased flows of FDI and ODA,[7] as well as a rise in commodity prices induced by increased global demand. While rising oil prices were key in spurring growth in oil-producing African countries, such trends posed a threat to the growth of non-oil producing African countries.

A. Strong global economic growth

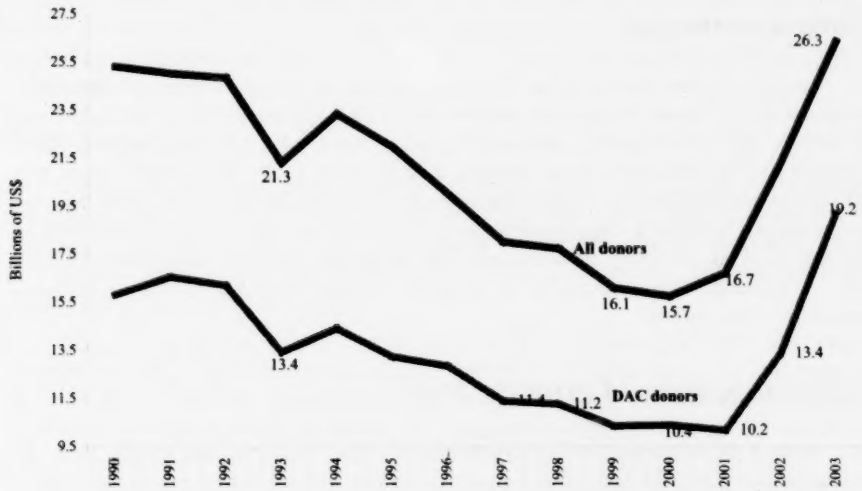
24. The global economy grew at 4 per cent in 2004, the strongest growth rate in two decades. Global growth was widespread, but particularly robust in the United States and China, which experienced growth rates of 4.4 and 9 per cent, respectively. At 1.8 per cent, growth in the European Union was relatively slow, and occurred against the backdrop of an appreciating euro that dampened exports. Given the importance of the European Union as a trading partner with Africa, the relatively slow growth in the European Union may have retarded the overall growth performance of Africa. Nonetheless, the generally strong global growth facilitated growth in developing countries, including African economies, by increasing global commodity demand.

B. Rising commodity prices

25. Africa's growth performance was spurred by rising oil and non-oil commodity prices. The commodity price index, denominated in United States dollars, increased by 26.3 per cent in 2004, induced by increased demand from Asia, particularly China. Changes in the price of oil accounted for the bulk of the commodity price increase, while metals, minerals and fertilizers contributed significantly to the rise

in non-energy commodity prices. In contrast, the price of cocoa, coffee, cotton and groundnut oil declined between 2003 and 2004 owing to an excess in supply on the world market.

Figure 4
Net flows of Official Development Assistance to Africa, 1990-2003
(Billions of United States dollars)



Source: Economic report on Africa 2005 (Economic Commission for Africa).

C. Official Development Assistance on the rise

26. Official Development Assistance (ODA) to Africa recovered from a low of $15.7 billion in 2000 to a new high of $26.3 billion in 2003 (see figure 4 above). The recovery in ODA flows was largely driven by debt relief, provided through the Heavily Indebted Poor Country Initiative (HIPC) and emergency assistance.

27. The Development Assistance Committee of the Organization for Economic Cooperation and Development (OECD) accounts not only for the bulk of ODA as a whole, but also a significant share of ODA to Africa in particular. In 2003, member countries of the Committee provided about 73 per cent ($19.2 billion) of total ODA and more than 41 per cent of all ODA flows to Africa. As per their per capita gross national income, Denmark (0.94), Norway (0.87), the Netherlands (0.81), Sweden (0.80) and Luxembourg (0.78) led the way in donations during the period from 2001 to 2003.

28. In absolute terms, the biggest beneficiaries of assistance from the Development Assistance Committee during this period were Egypt ($1.17 billion), Mozambique ($0.96 billion), the United Republic of Tanzania ($0.91 billion), the Democratic Republic of the Congo ($0.63 billion), and Ethiopia ($0.57 billion). It is noteworthy that most of these economies have been undergoing continuous economic reforms.

D. Foreign Direct Investment flows are up

29. Africa has been recording increased flows of FDI despite recent declines in such investment globally. FDI flows to Africa increased from $12 billion in 2002 to $15 billion in 2003 and were projected to rise to $20 billion in 2004.

30. FDI flows to Africa tend to be concentrated regionally (North Africa) and sectorally (in the extractive industries). Two thirds of all flows to Africa went to North Africa, where investments favoured oil-rich countries, including the Libyan Arab Jamahiriya, the Sudan and investor-friendly Morocco. In Sub-Saharan Africa, the preferred recipients of FDI were: Angola, Nigeria, Equatorial Guinea and South Africa.

31. FDI flows to the service sector at large and to the electricity and wholesale and retail sub-sectors in particular have been on the rise in recent years, challenging the dominance of the extractive industry. In particular, increased FDI flows to the service sector have been influenced by privatization and liberalization of the sector (for example telecommunications, electricity and water) and technological innovations that have increased the range of tradable services.

IV. Areas of concern

32. Notwithstanding the favourable growth performance in 2004, savings and investment remain low. Meanwhile, the depreciation of the United States dollar has contributed to the appreciation of the currencies of several African countries and threatens to undermine their international competitiveness. Furthermore, the global growth rate is expected to decline to 3.2 per cent in 2005 owing to rising crude oil prices, tighter fiscal and monetary policies in the United States in order to address the deterioration of its budget and current account deficits and a cooling of the Chinese economy. A slowdown in global growth may have adverse implications for African countries.

A. Risk of currency appreciation

33. As a result of continued weakening of the United States dollar, 30 African countries experienced appreciation of their currencies against the dollar in 2004. The Liberian dollar showed the sharpest appreciation of all African currencies owing to increased donor inflows, capital investment and remittances inflow and the decline in capital flight as the country emerged from conflict.

34. Higher gold and platinum prices, the weak United States dollar and relatively low real interest rates were the main factors behind the strong performance of the South African rand in 2004. The currencies of three Southern African countries (the Namibian dollar, the loti of Lesotho and the lilangeni of Swaziland), pegged at the same level to the rand, also experienced rapid appreciation. The CFA franc, pegged to the euro, also gained strength against the United States dollar in 2004.

B. Weak domestic investment

35. Investment in Africa is generally low. It barely exceeded 20 per cent of GDP during 2000-2002.[8] Only 11 out of the 50 countries for which data are available experienced high investment rates, that is, in excess of 25 per cent during 2000-2002, with a majority of these countries being oil-producing (see figure 5 below).

Figure 5
Investment to GDP ratios in Africa in 2000-02
(Percentage)

Source: Economic report on Africa 2005 (Economic Commission for Africa).

C. Low domestic savings

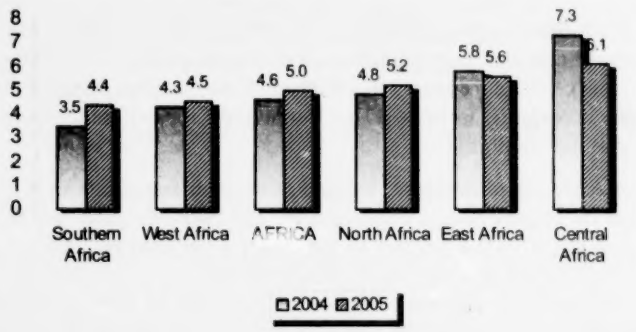
36. The low level of investment in Africa is partly due to the low savings rate in the region. On average, Africa had a savings rate of 21.1 per cent of GDP during 2000-2002. Only 11 of the 50 countries[9] registered savings rates above the average for the region, suggesting that even the average rate is dominated by the performance of a few countries (see figure 6 below).[10] The low level of domestic savings deepens the dependence of African countries on external aid and renders them vulnerable to the volatilities of FDI and ODA flows.

Figure 6
Savings to GDP ratios in Africa in 2000-02
(Percentage)

V. Prospects for growth in 2005

37. African economic growth is projected at 5 per cent in 2005, up from 4.6 per cent in 2004 (see figure 7 below). Growth is expected to be driven by the upturn in the growth prospects of 32 African countries (including the largest five economies,[11] except Nigeria). Growth will be underpinned by continued macroeconomic stability; rising African exports in the context of strong, albeit slower, global growth; continued improvement in agricultural output, assuming continued good weather conditions; and vibrant growth in the tourism and mining sub-sectors.

Figure 7
Projected real GDP growth at subregional level in 2005
(Percentage)



Source: Economic report on Africa 2005 (Economic Commission for Africa).

38. Central Africa and Eastern Africa are expected to lead the growth process in 2005, while Southern Africa and West Africa are projected to grow at the slowest rate (see figure 7 above). Growth in Central and Eastern Africa is, however, projected to be lower in 2005 than in 2004.

39. Growth in Central Africa is expected to decline owing to a projected sharp drop in Chad's growth from 39.4 per cent in 2004 to only 13 per cent in 2005. This is due to the winding down of construction activities on the Chad-Cameroon oil pipeline. Cameroon's growth is expected to remain unchanged while a further decline in oil production in Gabon is anticipated to slow the economy's growth to 0.8 per cent in 2005. On the other hand, robust expansion in the non-energy sectors is expected to strengthen the growth outlook in the Congo and Sao Tome and Principe.

40. Despite an anticipated decline from its 2004 growth level, East Africa's growth is expected to remain firm in 2005 owing to increased donor support across the subregion, good harvests (Burundi, Ethiopia, Kenya, Madagascar, United Republic of Tanzania and Uganda); strong growth in tourism (Kenya, Seychelles and United Republic of Tanzania); increased FDI flows (Madagascar and Uganda); good macroeconomic management (Uganda, Democratic Republic of the Congo and United Republic of Tanzania); and improved political stability (Burundi and Comoros).

41. Growth in North Africa is anticipated to rise in 2005 as a result of increased agricultural growth and continued gains from oil. Other factors include tax cuts in Egypt, which are expected to boost private consumption and investment; strong tourism growth in Morocco and Tunisia; more foreign investment inflows to the oil-sectors of the Libyan Arab Jamahiriya, Mauritania and the Sudan (if peace is secured); and strong growth in services in Tunisia and Mauritania. Aided by the expanded capacity in the oil sector and an improvement in the political situation, the Sudan is expected to expand at the fastest rate, 8 per cent, in 2005, followed by Algeria (6.6 per cent), Mauritania (5.4 per cent) and Tunisia (5.1 per cent).

42. West Africa is projected to improve slightly on its growth performance in 2004. Eight of the 15 countries (Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Guinea, Guinea-Bissau, Mali and Senegal) are expected to improve on their 2004 growth performance. Liberia is again projected to lead the subregion with a growth rate of 15 per cent. The main factors behind the expected rise in the growth in West Africa are: anticipated agricultural growth (Benin, the Gambia, Guinea, Mali, Senegal, Sierra Leone and Togo); increased donor support (Guinea-Bissau, Liberia and Sierra Leone); mining expansion (Burkina Faso, Guinea, Ghana, Mali, Sierra Leone); foreign investment inflows (Cape Verde and Liberia); and growth in tourism (Cape Verde and the Gambia).

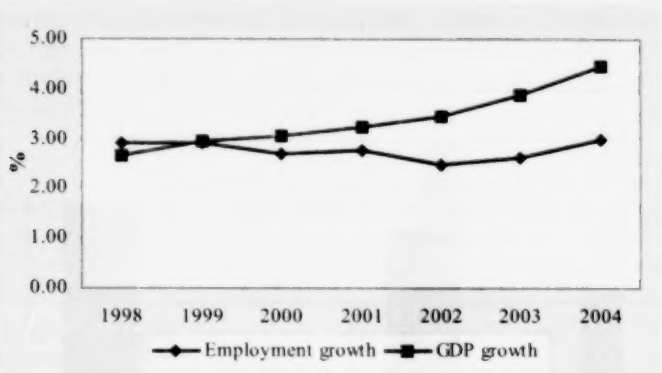
43. Southern Africa is projected to expand at a much faster rate of 4.4 per cent in 2005 compared to its growth rate of 3.3 per cent in 2004. Growth in South Africa is expected to increase from 2.8 percent in 2004 to 3.4 per cent in 2005 because of the anticipated strong global demand for its products, growth in tourism, an increase in FDI inflows, expansion in domestic demand in response to new tax-relief measures and a low interest rate environment. Developments in the oil sector will continue to influence Angola's economic activity in 2005. Furthermore, growth in services in Botswana, Mauritius and Namibia, an increase in mining sector activities in Botswana, Mozambique, Namibia and Zambia, expansion of the agricultural sector in Mauritius, Mozambique and Zambia, development in tourism in Mauritius and Zambia and donor support in Zambia will be the main factors that contribute to the expansion of the subregion's growth in 2005. Economic growth in Zimbabwe, however, is projected to contract in 2005 (albeit at a lower rate than in 2004) owing to the continuing unfavourable political climate and the weak performance of both the agricultural and manufacturing sectors.

VI. Growth, employment and poverty

44. Given the significance of employment as a source of income for the poor, increasing employment opportunities must be considered a critical element of poverty reduction initiatives. Furthermore, sustained economic growth represents the route for creating "decent" jobs with above-poverty wages.

45. Unfortunately, while real GDP growth in Sub-Saharan Africa has been on an upward trend since 1998, employment growth has remained flat (see figure 8 below). These trends suggest, that real GDP growth in Sub-Saharan Africa has not been sufficiently employment-intensive.

Figure 8
Real growth in GDP and employment growth in Sub-Saharan Africa
(Percentage)

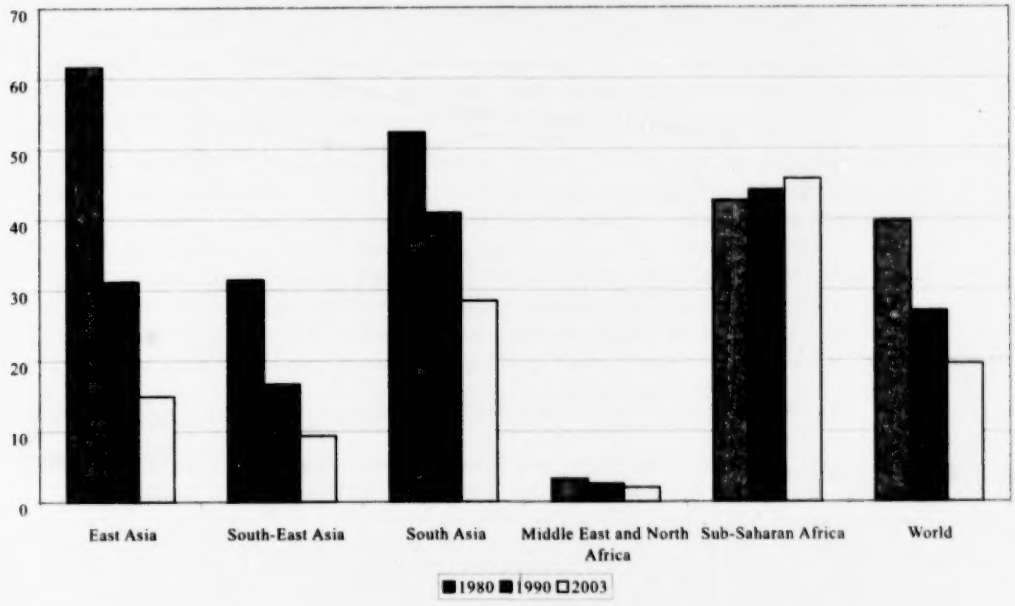


Source: Economic report on Africa 2005 (Economic Commission for Africa).

A. Poverty trends

46. In 2003, Sub-Saharan Africa had the highest poverty rate, while North Africa and the Middle East experienced the lowest rate (see figure 9 below). Moreover, the poverty rate decreased substantially between 1980 and 2003 in all regions, with the exception of Sub-Saharan Africa, where the rate actually increased slightly.[12] In addition, Sub-Saharan Africa was the only region where the proportion of the "working poor" increased during 1980-2003 (see table 2 below). This finding is likely explained by the fact that GDP growth in Sub-Saharan Africa during this period was barely enough to absorb population growth.[13]

Figure 9
Poverty rate in selected regions measured in terms of people living on 1 United States dollar per day



Source: Economic report on Africa 2005 (Economic Commission for Africa).

Table 2
Working poverty shares in total employment, selected regions
(United States dollars)

	$1-a-day poverty			*$2-a-day poverty*		
	1980	*1990*	*2003*	*1980*	*1990*	*2003*
East Asia	71.1	35.9	17.0	92.0	79.1	49.2
South-East Asia	37.6	19.9	11.3	73.4	69.1	58.8
South Asia	64.7	53.0	38.1	95.5	93.1	87.5
Middle East and North Africa	5.0	3.9	2.9	40.3	33.9	30.4
Sub-Saharan Africa	53.4	55.8	55.8	85.5	89.1	89.0
World	40.3	27.5	19.7	59.8	57.2	49.7

Source: Economic report on Africa 2005 (Economic Commission for Africa).

VII. Progress towards the Millennium Development Goals

47. The unsatisfactory performance of Sub-Saharan Africa in creating jobs and reducing poverty raises concerns about the subregion's progress in meeting the

overall targets of the Millennium Development Goals,[14] practically all of which relate to social conditions. The overall performance of the countries of the region during the period from 1990 to 2000, with respect to achieving the Millennium Development Goals has been disappointing (see table 3 below).[15] Performance on halving poverty, reducing maternal mortality and increasing the primary education completion rate was particularly weak, although there appears to have been significant progress on meeting gender-equality education targets, as well as on providing access to improved water supply.

Table 3
Progress towards meeting the Millennium Development Goals in Sub-Saharan Africa

Millennium Development Goal	*1990*	*2000*	*2015 (Target)*
No. 1: People living on less than $1 (purchasing power parity (PPP)) a day (per cent of population)	45	46	22
No. 2: Primary education completion rate (per cent of relevant age group)	57	55	100
No. 3 (a): Promoting gender equality: primary education	0.82	0.87	1
No. 3 (b): Promoting gender equality: secondary education	0.75	0.82	1
No. 4: Under five mortality rate (per 1,000 births)	187	174	62
No. 5: Maternal mortality rate (per 100,000 live births)	920[a]	917	230[a]
No. 6: Combating HIV/AIDS, malaria and other diseases:	—	—	—
HIV/AIDS — In 2001 youth prevalence was 13 per cent for men and 6 per cent for women.			
Malaria — Only 7 out of 27 countries in Sub-Saharan Africa with above-5 per cent incidence use bed nets for prevention.			
Tuberculosis — Prevalence of 350 per 100,000 in Sub-Saharan Africa in 2001.			
No. 7 (a): Access to improved water source (per cent of population)	54[a]	58	77
No. 7 (b): Access to improved sanitation services (per cent of population)	55[a]	54	77
No. 8 (a): ODA flows (per cent of donors' gross national income)	On the decrease	Increase to 0.3 per cent[b] in 2003	0.7 per cent as agreed in Monterrey
No. 8 (b): Debt sustainability	N/A	Currently (2004) 12 African countries have reached completion point	—

Source: www.developmentgoals.org; [a]United Nations database and [b]Development Assistance Committee of the Organization for Economic Cooperation and Development.

48. The apparently dismal performance at the regional level masks subregional and country-level differences. North Africa, for example, is singled out as a subregion making remarkable progress towards achieving the Millennium Development Goals (see table 4 below). It is also noteworthy that several countries are projected to achieve all of the goals. Nonetheless, the majority still lag behind, and special efforts will be required to ensure that they can achieve the Goals.

Table 4
Achieving the Millennium Development Goals in Africa: country and subregional performance

Goals	*Countries that are likely to achieve the targets*
Goal 1 **Eradicate extreme poverty and hunger**	**Poverty**: Burkina Faso, Lesotho, Botswana, Cameroon, South Africa, Mauritius, Uganda, Ghana and North African countries. **Child malnutrition**: Botswana, Chad, Gambia, Mauritania, Egypt, the Sudan and Tunisia. **Overall undernourishment**: Ghana, Malawi and Angola and North African countries
Goal 2 **Achieve universal primary education**	**Both net enrolment and completion rate**: Algeria, Egypt, Tunisia, Botswana, Cape Verde, Seychelles, Togo, Zimbabwe, Mauritius, Namibia, South Africa, Gabon, Rwanda and Sao Tome and Principe
Goal 3 **Promote gender equality**	**Primary level education**: Botswana, Lesotho, Mauritius, Namibia, Rwanda, Swaziland, and Zimbabwe. **Secondary level:** Algeria, Libyan Arab Jamahiriya, Tunisia, Botswana, Lesotho, Namibia, and Rwanda
Goal 4 **Reduce child mortality**	Mauritius, Seychelles, Cape Verde and North African countries.
Goal 5 **Improve maternal mortality**	North African countries, Botswana, Cape Verde, Gambia and Mauritius
Goal 6 **Combat HIV/AIDS, malaria and other diseases**	**HIV/AIDS**: Botswana, Zimbabwe and Uganda. **Malaria**: Gambia, Guinea-Bissau, Comoros, Benin, and Rwanda, Central Africa, Cameroon and Kenya. **Tuberculosis:** South Africa, Swaziland, Zambia, Angola, Gabon, Gambia and Madagascar and North African countries in all the three cases (HIV/AIDS, malaria, and tuberculosis)
Goal 7 **Ensure environmental sustainability**	**Sustainable development (forest area)**: North African countries, Swaziland, the Gambia and Cape Verde. **Access to safe drinking water (rural)**: Egypt, Mauritius, Algeria, Botswana, Burundi, Malawi, South Africa, United Republic of Tanzania, Ghana, Gambia and Namibia. **Access to sanitation (urban)**: Libyan Arab Jamahiriya, Morocco, Egypt, Tunisia, Algeria, Ghana, and Mauritius.

Source: Economic Commission for Africa, Progress and Prospects of Achieving the Millennium Development Goals in Africa, 2005.

VIII. Conclusion and policy recommendations

49. The country-level performance of African countries towards achieving the Millennium Development Goals is cause for unrelenting concern but not for despair. Africa's favourable real GDP performance in recent years is a welcome development, especially when placed in the context of historically low levels of growth.

50. Sustainable growth in Africa will, however, require policy interventions at the economic, social, and political levels. At the economic level, priority must be given to:

(a) Minimizing dependency on the vagaries of the climate, through agricultural transformation;

(b) Reducing exposure to commodity price shocks via export diversification;

(c) Consolidating macroeconomic stability through prudent fiscal and monetary policies underpinned by effective expenditure tracking systems and an efficient public sector;

(d) Mobilizing domestic savings to finance investments, including through macroeconomic stability and measures to deepen financial and capital markets;

(e) Maximizing job creation by minimizing constraints to private sector investments and growth (for example, complementary public investments in roads and utilities and minimization of red-tape); and by implementing employment policies that reduce gender disparities with regard to access to economic opportunities;

(f) Minimizing the unpredictability of ODA flows by negotiating greater donor coordination and commitment to streamlining aid delivery modalities and, where relevant, ensuring greater effort on the part of African countries to fulfil mutually agreed benchmarks with donors;

(g) Accelerating efforts of regional cooperation to effectively harness global forces for development.

51. Interventions in the social sector must be guided by the goal of improving the health and human capital of the citizenry. This can be achieved by:

(a) Maximizing physical and financial access to health systems by the poor, through cost-effective investments in social services, including the design of financially sustainable social safety nets;

(b) Addressing the adverse effects of major diseases such as malaria and especially, halting the spread of HIV/AIDS as well as addressing the needs of people living with HIV/AIDS;

(c) Investing in education and ensuring that human capital (acquired either through formal education or skills training) is relevant to the workplace and putting in place effective policies to retain human capital and reverse the brain drain;

(d) Addressing reproductive health issues in order to reduce maternal mortality.

52. At the political level, the overriding objectives should be:

(a) Securing peace and security through the development of credible democratic processes and institutions, including the respect for the rule of law and the rights and liberties of the citizenry; providing for the rule of the majority while respecting the rights of minorities;

(b) Making special provisions for the least developed countries and post-conflict economies;

(c) Optimizing global partnerships to level the playing field in the trade arena; as well as developing and maintaining the capacity for infrastructure development and effective management.

Notes

[1] Nigeria, which constitutes the lion's share of the West African economy, requires special attention. The steep decline in the growth of its GDP between 2003 and 2004 must be placed in context, since it represents a return to a growth trend that had been interrupted by a decline in oil production in 2002, caused by civil protest in the oil rich Niger Delta. The growth of Nigeria's GDP in the oil sector plummeted from 1.4 to negative 11.6 per cent between 2001 and 2002 (IMF country report, 2005). Hence, the 10.2 per cent growth rate in 2003 reflects a rise from an unusually low base in 2002.

[2] The high growth of Chad, Equatorial Guinea and Angola also benefited from higher oil prices, while the construction of the Chad-Cameroon oil pipeline added considerably to the astronomically high growth rate in Chad. This pipeline should also help to continue fuelling Chad's growth in the future by facilitating its sale of oil in international markets.

[3] Oil production during the first half of 2004 was 2 per cent below the level achieved in 2003. Gabon is currently undertaking investments to upgrade existing oil fields in order to capitalize on favourable oil prices (IMF country report No. 05/3).

[4] Fortunately, with a more equitable distribution of income than the current average for sub-Saharan Africa, countries would be able to achieve Millennium Development Goal No. 1 with less growth than the estimated 7 per cent, since poverty reduction would be more responsive to growth (Fosu, A. K. "Inequality and the Growth-Poverty Nexus: Evidence from sub-Saharan Africa," a paper presented at the conference of the Centre for the Study of African Economies on "Understanding Poverty and Growth in sub-Saharan Africa", University of Oxford, March 2002).

[5] The deflation resulted from: increased food supply from carry-overs from the previous year and a weak domestic demand due in part to a contraction in Government spending. Government spending contracted as a result of a shortfall in non-oil revenue and late receipt of oil receipts due to delays in the finalization of the institutional arrangements for the management of oil revenues.

[6] Sao Tome and Principe (17.2 per cent), Guinea-Bissau (14.7 per cent), Malawi (12.7 per cent), Zimbabwe (9.7 per cent), Egypt (7.5 per cent), Swaziland (6.6 per cent), Morocco (5.9 per cent), Sierra Leone (5.9 per cent), Mauritius (5.5 per cent) and Angola (5.4 per cent).

[7] Based on the most recently available ODA data (2003).

[8] This is the most recent period for which reliable data is available.

[9] These are countries for which data is currently available.

[10] It should be noted, however, that while high investment rates (i.e., at least 25 per cent of GDP) are critical for growth, they are not sufficient. For instance, despite the high investment rates in Algeria, Gabon and the Seychelles during 2000-2002, the average growth rates in these countries were less than 5 per cent over the same period. This underscores the need to examine country-specific factors underpinning productivity.

[11] South Africa, Nigeria, Egypt, Algeria and Morocco.

[12] The poverty rate in North Africa and the Middle East was already low in 1980, but still decreased slightly between 1980 and 2003.

[13] The per capita growth of GDP actually averaged negative 0.2 per cent during 1980-2003, compared, for example, with an average of 2 per cent for North Africa.

[14] North Africa as a whole is on target toward meeting practically all of the Millennium Development Goals (see table 4 below).

[15] The most recent year for which reliable data is available is 2000.

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Summary of the economic and social survey of Asia and the Pacific, 2005

Summary

The earthquake and tsunami disaster of 26 December 2004 took over 280,000 lives and devastated coastal areas and communities around the Indian Ocean. It occurred too late to affect economic performance for 2004, but the impact on economic growth in 2005 will be very severe in some cases. Despite the increase in oil prices, the weakness of the dollar and softening external conditions in the latter part of the year, in 2004 economies of member States of the Economic and Social Commission for Asia and the Pacific (ESCAP) grew at their fastest pace since 2000, with broad-based growth accompanied in most cases by low inflation, in part owing to fuel subsidies. Growth was driven by increased exports, a large part of which were within the region, particularly to China, as well as strong domestic demand, including a revival in capital expenditure. Prospects for 2005 indicate a slowdown in economic growth in the ESCAP region as the external environment weakens, with a pickup in inflation as higher oil prices affect the general economy. However, forecasts for 2005 are subject to a higher margin of error than before. Nevertheless, increased macroeconomic stability and external strength in the region should enable the economies in the region to withstand most shocks while working to reduce poverty, implementing ongoing reform programmes and sustaining competitiveness.

The most important feature of the demographic transition in the next half-century, with respect to Asia and the Pacific, is the rapid ageing of populations in countries that are still developing. Relative ageing of the older population itself and a rising share of women in older age groups are becoming notable features of the ageing process in the region. Governments will increasingly be under pressure not only to devise innovative mechanisms to deal with issues arising from an ageing

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population but also to ensure the long-term viability of social welfare programmes, while minimizing negative effects on the economy. The diversity of ageing in the region means that different policy responses are called for in different countries, depending on their current and expected levels of ageing. Fundamental changes in policy design, particularly in health and pension systems, will be necessary in many developing countries to minimize the pressures on service delivery, public expenditure and the overall growth potential of the economy.

The year 2005 was designated as the International Year of Microcredit, with the objective of promoting the role of microfinance and microcredit in poverty reduction. The Asia-Pacific region has a wide range of experiences in providing microfinance to the poor. The *Survey* highlights some of those experiences to facilitate a way for many poor people living in the region to improve their lives through their own efforts.

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I. Implications of recent economic and social developments

1. The *Economic and Social Survey of Asia and the Pacific, 2005*, looks at trends in the regional economy in 2004 and the policy choices facing the region. It also considers longer-term issues relating to the dynamics and diversity of trends in population ageing in the region. Finally, it contains a special feature on microcredit.

2. The earthquake and tsunami disaster of 26 December 2004, the world's worst natural disaster in living memory, took over 280,000 lives and devastated coastal areas and communities around the Indian Ocean. The provinces of Aceh and northern Sumatra in Indonesia were the worst-affected areas but the impact of the disaster on gross domestic product (GDP) growth is likely to be greatest in the smaller economies, such as Maldives and Sri Lanka, owing to their heavy reliance on tourism and fisheries. However, the overall impact of the disaster on economic performance in the region in 2005 is likely to be small.

3. The year 2004 produced the fastest global economic growth in almost three decades and the economic performance of the economies in the ESCAP region was also impressive, with an estimated growth rate of 7.2 per cent, the highest since 2000, accompanied by generally low rates of inflation (see table). The acceleration in GDP growth was most marked in East and North-East Asia, South-East Asia and the developed countries of the region, but other subregions maintained growth rates close to the levels of a year earlier. In general, growth was broadly based, supported by robust export growth and higher commodity prices as well as strong domestic demand driven by low interest rates. In particular, capital expenditure revived in many countries and foreign direct investment inflows into the region also increased sharply in 2004. The experience with inflation was more mixed, with three regions having somewhat higher inflation in 2004 as compared with 2003 and with three others having significantly lower inflation, particularly in the Pacific island economies. The overall rate of inflation in developing economies of the ESCAP region was unchanged from the previous year at 4.8 per cent in 2004.

4. The impressive economic performance in the region reaffirms the resilience of the regional economy in the face of a series of ongoing and new challenges, not the least of them the record increases in nominal crude oil prices that contributed to some loss in growth momentum in the second half of 2004 as well as to a reversal in inflationary expectations in the region. Some central banks began to raise interest rates pre-emptively, albeit in small steps to counter the risk of potentially higher inflation in 2005, signalling the end of the low-inflation, low-interest rate environment of the last two years.

5. Compounding developments in the energy markets, output growth in two important sources of external demand in the region, the United States of America and Japan, slowed somewhat in the former and showed signs of a recession in the latter in the second half of 2004. Any marked or prolonged slowdown in the momentum of growth would generate immediate social and economic repercussions for the region in terms of poverty reduction and longer-term development prospects if public investment in social and physical infrastructure were to be reduced. However, economic growth in the region has become more autonomous in the last few years with rapid increases in intraregional trade. Rapid growth in China has been instrumental in this process and prospects for 2005 will be conditioned by the success of Chinese authorities in achieving a "soft" landing.

Selected economies of the ESCAP region: rates of economic growth and inflation, 2003-2006

(Percentage)

	Real GDP				*Inflation*[a]			
	2003	*2004*[b]	*2005*[c]	*2006*[c]	*2003*	*2004*[b]	*2005*[c]	*2006*[c]
Developing economies of the ESCAP region[d]	6.3	7.2	6.2	6.2	4.8	4.8	4.6	4.0
East and North-East Asia	6.2	7.5	6.3	6.2	1.4	3.2	3.1	2.6
China	9.3	9.5	8.5	7.8	1.2	3.9	4.0	3.0
China, Hong Kong SAR	3.2	7.9	5.0	6.0	-2.5	-0.3	0.3	1.2
Mongolia	5.5	6.0	6.0	5.0	4.6	11.0	4.7	..
Republic of Korea	3.1	4.7	4.0	4.6	3.6	3.6	3.0	2.9
Taiwan Province of China	3.3	5.9	4.2	4.1	-0.3	1.7	1.5	1.5
North and Central Asia	7.6	7.2	6.5	6.3	12.9	10.2	7.7	8.2
Armenia	13.9	10.1	6.5	6.0	4.7	7.0	2.6	3.0
Azerbaijan	11.2	10.2	14.0	10.0	2.2	6.7	5.0	7.4
Georgia	11.1	8.4	5.0	5.0	4.8	5.7	5.6	5.8
Kazakhstan	9.2	9.4	8.5	8.0	6.4	6.9	6.6	7.1
Kyrgyzstan	6.7	7.1	6.0	6.5	3.1	4.1	3.5	3.6
Russian Federation	7.3	7.1	6.3	6.1	13.7	10.9	8.0	8.6
Tajikistan	11.0	10.6	5.0	7.0	17.1	6.8	8.0	6.0
Turkmenistan	17.0	7.0	11.0	7.0	6.5	9.0	8.0	7.0
Uzbekistan	4.4	4.9	5.3	6.4	13.1	2.4	2.8	3.1
Pacific island economies	3.0	3.0	2.6	2.4	10.6	3.3	3.6	..
Cook Islands	3.1	2.7	2.9	..	2.4	1.9	2.4	..
Fiji	3.0	3.8	1.5	0.7	4.2	3.5	3.0	..
Papua New Guinea	2.8	2.6	2.9	2.4	14.7	2.9	3.8	..
Samoa	3.5	4.0	3.5	..	0.1	3.0	3.0	..
Solomon Islands	5.6	4.2	4.4	..	8.3	5.6	2.5	..
Tonga	2.9	1.6	2.8	..	11.6	11.0	11.0	..
Vanuatu	2.4	3.2	2.9	2.5	2.5	2.6	2.5	..
South and South-West Asia[e]	7.2	7.4	6.4	6.7	10.0	6.8	6.8	5.5
Bangladesh	5.3	5.5	5.2	5.8	4.4	5.8	6.8	5.9
Bhutan	6.5	7.0	8.0	..	1.8	1.2	..	..
India	8.5	6.9	7.2	7.3	3.9	3.8	4.0	4.0
Iran (Islamic Republic of)	6.7	7.1	7.1	7.4	15.6	14.5	14.5	11.5
Nepal	3.1	3.7	4.0	5.0	4.8	4.0	5.5	4.6
Pakistan	5.1	6.4	6.6	7.2	3.1	4.6	5.0	5.0
Sri Lanka	5.9	5.2	5.0	6.0	6.3	7.6	12.0	6.0
Turkey	5.8	9.6	4.8	5.1	25.3	10.7	9.6	6.1
South-East Asia	4.9	6.4	5.7	5.8	3.2	4.1	4.5	3.9
Cambodia	5.2	4.3	1.9	4.3	1.1	2.0	3.0	3.7
Indonesia	4.9	5.1	5.5	5.7	6.6	6.1	7.0	5.8

	Real GDP				Inflation[a]			
	2003	2004[b]	2005[c]	2006[c]	2003	2004[b]	2005[c]	2006[c]
Lao People's Democratic Republic	5.9	6.5	7.0	7.0	15.5	11.2	7.7	5.4
Malaysia	5.3	7.1	6.0	6.1	1.2	1.4	2.2	2.7
Myanmar[f]	0.0	3.6	3.3	3.0	20.0	35.0	40.0	45.0
Philippines	4.7	6.1	5.3	5.2	3.5	6.0	6.0	5.0
Singapore	1.4	8.4	5.2	4.9	0.5	1.7	1.4	1.3
Thailand	6.9	6.1	6.0	6.3	1.8	2.7	3.2	2.4
Viet Nam	7.3	7.7	8.5	8.0	3.0	9.5	6.5	8.0
Developed economies of the ESCAP region	1.4	2.7	1.6	1.3	-0.1	0.2	0.3	0.4
Australia	3.0	3.5	3.0	3.0	2.8	2.3	2.8	2.7
Japan	1.3	2.6	1.5	1.1	-0.3	0.0	0.1	0.2
New Zealand	3.3	4.8	2.7	2.9	1.8	2.3	3.0	2.8

Sources: Economic and Social Commission for Asia and the Pacific, based on national sources; International Monetary Fund, *International Financial Statistics*, vol. LVII, No. 10 (Washington D.C., October 2004); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 2004* (Manila, 2004) and *Asian Development Outlook 2004 Update* (Manila, 2004); Economic Intelligence Unit, *Country Reports* and *Country Forecasts* (London, 2004 and 2005), various issues; and website of the Interstate Statistical Committee of the Commonwealth of Independent States, http://www.cisstat.com, 26 October 2004 and 3 February 2005.

[a] Changes in the consumer price index.

[b] Estimate.

[c] Forecast/target.

[d] Based on data for (developing) economies representing more than 95 per cent of the population of the region (including the Central Asian republics); GDP figures at market prices in United States dollars in 2000 (at 1995 prices) have been used as weights to calculate the regional and subregional growth rates. In the case of Pacific island economies for 2006, estimates based on figures available.

[e] The estimates and forecasts for countries relate to fiscal years defined as follows: fiscal year 2004/05 = 2004 for India, the Islamic Republic of Iran and Myanmar; and fiscal year 2003/04 = 2004 for Bangladesh, Nepal and Pakistan.

[f] Inflation at the end of the period.

6. The strong growth of the global economy in 2003 and 2004 was both reflected in and driven by strong growth in world trade. The ESCAP region is a major contributor to world trade growth, with both exports and imports growing faster than world exports and imports and with China becoming the world's third-largest trading nation. However, trade flows are not static, and Governments in the region need to be alert to structural changes occurring in those flows to assist businesses in adapting to such changes. In that regard, the expiry of the Arrangement Regarding International Trade in Textiles (Multifibre Arrangement) on 1 January 2005 is expected to benefit China, India and Pakistan but will adversely affect a number of smaller economies in the region.

7. In tandem with an expected fall in world economic growth in 2005, growth in international trade is also expected to slow in real terms. Import demand within the developing economies is unlikely to compensate fully for the slowdown in the developed economies, but China will continue to be an important determinant of trade performance for most parts of the region. In this context, the adoption of the so-called "July package" has raised hopes for the Doha round of World Trade Organization negotiations and the momentum of regional and bilateral free trade agreements has continued in parallel in 2004 in the region.

8. Large current account imbalances continue to characterize the global economy, and a lower dollar would contribute to reducing the United States deficit. However, many economies in the ESCAP region have relied on American import demand as an important driver of growth, which would be choked off by a sizeable fall in the dollar. In addition, a fall in the dollar could also push up inflation in the United States, leading to higher American and global interest rates. Despite the firming up of interest rates in recent months, their very low levels over the past two years have encouraged the growth of a variety of alternative investment vehicles, primarily in the form of highly leveraged hedge funds, and excessive flows of speculative funds in Asia, both of which warrant closer attention to avoid potential upheavals in financial markets.

9. A factor worthy of note is that developing economies in the ESCAP region have become net exporters of capital as persistent current account surpluses in some countries combined with a sharp increase in net private capital flows have been reflected primarily in the substantial accumulation of official reserves. The matter raises significant policy issues for the countries concerned as well as for the region.

10. Prospects for 2005 indicate a slowdown in GDP growth in the ESCAP region to an estimated 6.2 per cent as the external environment weakens, with inflation slowing slightly to an estimated 4.6 per cent, based on the assumption that the average price of oil will be around 38 dollars ($) per barrel. However, the forecasts are subject to a higher margin of error than a year or so ago owing to the prevailing uncertainty regarding the future course of oil prices. In addition, shocks such as the tsunami disaster and avian influenza can have a significant impact on short-term growth. Furthermore, the different subregions of ESCAP as well as the individual economies are likely to respond very differently to the challenges of maintaining the present growth momentum, as highlighted below.

11. Overall growth in East and North-East Asia in 2004 climbed to 7.5 per cent, 1.3 percentage points higher than in 2003. As in the other subregions of the Economic and Social Commission for Asia and the Pacific, inflation increased in 2004 and is expected to stay high in 2005. Growth prospects for the subregion in 2005 are closely linked to the impact of measures that the Government of China is currently taking to slow its economy in 2005. The consensus of opinion is that the economy of China should decelerate gradually to a more sustainable pace in 2005 and beyond and by so doing would provide ample policy space for countries and economies in the subregion, as well as in the wider ESCAP region, to adjust.

12. There is a need for the authorities in China to introduce greater flexibility in establishing and implementing interest and exchange rate policies and to continue with reform measures. While the fiscal situation is not currently a matter of concern in most countries of the subregion, steps to ensure fiscal soundness may be necessary in Hong Kong, Special Administrative Region (SAR) of China.

13. Data for 2004 indicate that North and Central Asia enjoyed another year of buoyant growth, although marginally slower than the pace attained in 2003. The rate of inflation decelerated in the Russian Federation and Uzbekistan, but still remained high in the former. Significant price pressures emerged in the other subregional economies. Prospects for 2005 in the subregion are for a moderation in output growth and in inflation as oil and other commodity prices ease in the months ahead.

14. The energy sector has been the main driver of growth in much of North and Central Asia, accounting for approximately one third of GDP and over one half of exports in Kazakhstan and the Russian Federation. However, a backlog of investments in pipeline and port capacity and more generally in energy infrastructure has put a limit on growth in the sector, at least in the short term. In addition, despite reforms in recent years, the non-oil sectors of the economy are not yet a viable alternative source of growth.

15. Real GDP growth continued at a modest pace in 2004 in the Pacific island economies. Higher prices for commodity exports, including oil in the case of Papua New Guinea, and increased tourism supported positive growth. Improved economic management has reduced budget deficits and lowered public debt and, as a result, monetary management has been able to improve inflation performance greatly. However, the rise in oil prices could jeopardize the progress made if the increase is maintained in 2005. The outlook for 2005 is for a slowdown in economic growth as commodity prices decline but for a slight increase in inflation.

16. A notable feature of the Pacific island economies is that macroeconomic stabilization has not resulted in faster economic growth so far, principally owing to the absence of an investor-friendly environment. Political instability and poor governance are major contributors to the poor climate for investment, as are corruption and law-and-order problems. Insufficient attention to rural development continues to undermine poverty reduction efforts in the subregion. Finally, policies to ensure sustainable development and prevent the overexploitation of natural resources are urgently needed.

17. Economic growth improved marginally in 2004 in the developing economies of South and South-West Asia on the relatively high rate attained the previous year despite poor weather in South Asia and the higher cost of oil. Rates of inflation picked up in Pakistan and Sri Lanka, falling somewhat in India and the Islamic Republic of Iran and more sharply in Turkey. The outlook for 2005 is for a continuation of the present inflation trends in most cases, with overall GDP growth in the subregion forecast to be 1 percentage point down from 2004. In particular, GDP growth is expected to be 1 per cent lower than predicted earlier in Sri Lanka owing to the effects of the tsunami.

18. In recent years, all the economies in South and South-West Asia have benefited from structural reform programmes that have sought to stabilize and improve macroeconomic fundamentals and provide production incentives for both agriculture and manufacturing on a sustained basis. However, success in this regard has been uneven. Fiscal consolidation has made limited headway, and, with interest rates now rising, the effect on the budget of a higher burden of debt servicing could be a matter of some concern.

19. Among the least developed countries in South Asia, economic growth improved modestly, although Afghanistan and Bangladesh were affected by bad weather. Maldives was devastated by the tsunami of December 2004, which will have a severe impact on its performance in 2005. Political events in a number of the least developed countries are also expected to influence progress in 2005. Inflation was generally lower in 2004, partly owing to currency appreciation, which offset the sharp increase in petroleum prices to some extent. Despite the expiry of the Multifibre Arrangement, the external sector is expected to become an increasingly

important source of economic growth as a result of increased trade liberalization and regional integration.

20. GDP growth in South-East Asia in 2004 exceeded expectations and improved on 2003 growth by the wide margin of 1.5 percentage points. Growth was broadly based in most countries, and manufacturing, in particular, benefited from the upturn in the electronics cycle and strong export demand. Higher food and energy prices put upward pressure on price levels in the subregion, which was partially offset by fuel subsidies in some countries. While the earthquake and tsunami disaster lowered expected growth in 2005 somewhat in Thailand, Indonesia is still expecting GDP growth to increase next year. For the subregion as a whole, the collective GDP growth rate is expected to ease by around 0.7 per cent in 2005. While high commodity prices boosted several economies in the subregion in 2004, with Indonesia, Malaysia and Viet Nam benefiting from the higher prices, the use of oil price subsidization in several countries, particularly Indonesia, Malaysia and Thailand, is likely to pose a difficult fiscal problem before too long.

21. There is a general view that financial and corporate restructuring has been largely completed in South-East Asia, while budget deficits have narrowed or, as in Thailand, the budget has remained in surplus. Better job creation and faster economic growth have helped to reduce poverty incidence in the subregion but policymakers continue to be preoccupied with the task of increasing the competitiveness of their economies, in part through greater public investment in infrastructure.

22. In the least developed countries in South-East Asia, economic growth continues to vary widely from year to year, depending on developments in the agricultural sector. With the exception of Myanmar, inflation tended to be lower in 2004 in all of these countries owing to greater exchange rate stability as well as to prudent monetary policies, although the rise in oil prices was beginning to affect the general price level. Development of the agricultural sector, which employs a significant portion of the labour force in the least developed countries of South-East Asia, is essential for poverty reduction, especially in rural areas. The expiry of the Multifibre Arrangement is also expected to affect industrial and export growth adversely in both Cambodia and the Lao People's Democratic Republic.

23. In the developed countries of the region, the recent revision of economic data from Japan seems to indicate that there was a shallow recovery in 2003 in that country after years of stagnation and that growth was much stronger in 2004, despite a slowdown in the second half of the year, but lower than previously thought. Growth also accelerated in New Zealand while remaining substantially unchanged in Australia in 2004, supported by buoyant domestic demand and high commodity prices. Economic growth is expected to moderate in 2005 in all three countries if the external environment weakens and uncertainty remains about the sustainability of domestic demand.

24. Deflationary pressures eased in Japan but firm evidence that deflation has ended is still awaited. The fiscal deficit continues to present a daunting challenge in Japan. The fiscal position in both Australia and New Zealand remained strong in 2004 but monetary policy was tightened in the latter in the face of a build-up of price pressures in recent months, and additional measures are expected if oil prices remain high. The boom in the housing market appears to have passed its peak in

Australia and inflation was subdued, but some increase in inflation is expected in both countries in the short term.

II. Policy issues and challenges

25. In the near term, the first issue with significant policy connotations for Governments in the region is that oil prices have aggravated the situation of already significant volatility and are likely to remain under upward pressure for some time. They thus pose a significant threat of inflation, and the uncertainty about their future course is likely to discourage investment. Second, there is a distinct risk that the external environment will deteriorate in the coming months. Third, those developments, together with a weakening dollar, will pose a major challenge to maintaining growth and macroeconomic stability in the months ahead. In that regard, Governments may wish to consider inflation targeting as a possible option, as well as acting to eliminate fuel subsidies. Regional cooperation to create an oil reserve to reduce oil price fluctuations may also be worth investigating.

26. There are several longer-term development policy issues facing the countries in the ESCAP region. First, the tsunami disaster illustrated the lack of a systematic disaster management framework, including disaster mitigation measures, in many countries. Policymakers will need to pay much more attention to disaster prevention and preparedness as outlined in the Hyogo Framework for Action 2005-2015: Building the Resilience of Nations and Communities to Disasters (A/CONF.206/6, chap. I, resolution 2), adopted at the World Conference on Disaster Reduction, held in Kobe, Japan, in January 2005.

27. The tsunami disaster also underscored the continuing challenge of poverty reduction in the region. It highlighted the importance of handling vulnerability to achieve a sustainable reduction in poverty in line with the first Millennium Development Goal. While most countries in the Asia-Pacific region are making progress in meeting that Goal, they are nevertheless likely to miss many of the Goals that do not relate to income. Reaching the targets within and across countries will require more resources, national as well as international, as well as a radical shift in attitudes, priorities and policies to ensure equitable, effective and sustainable basic services.

28. Achieving the twin challenges of sustaining growth and reducing inequality has high priority on the policy agenda of the region. Economic growth is not sustainable without human development, and for policymakers the focus must be on strengthening the links between the two. Some of the most important issues are employment opportunities, especially for the young; access to productive assets; public spending on the provision of basic social services; gender equality; and population policy and good governance. While the importance of good physical infrastructure is well known, social infrastructure is equally important and should be understood to incorporate an underlying "social contract" between citizens and the State. In that regard, a proper balance needs to be struck between the public and private provision of social services.

29. A final issue concerns the role of Governments in improving competitiveness at the enterprise and national levels. Competitiveness is determined by both real and monetary factors. The role that Governments can play in maintaining and enhancing competitiveness is either as a provider of public goods and social infrastructure or

as an enabler of the process, which also encompasses encouraging innovation and investment in technology by enterprises.

III. Dynamics of population ageing: how can Asia and the Pacific respond?

30. Population ageing, the process by which older individuals form a proportionately larger share of the total population, was one of the most distinctive demographic events of the late twentieth century. Its effects are amplified by declines in mortality and fertility rates, mainly as a result of improved health conditions and population policies in recent years.

31. The intensity of ageing in the region is bound to increase at a faster rate in the twenty-first century. The number of persons aged 60 years and over increased more than threefold in 50 years, from 96 million in 1950 to 326 million in 2000, representing 10 per cent of the population. An even faster rate of increase is expected in the next 50 years, raising the number of persons in this age group to over 1.2 billion by 2050, nearly one quarter of the population.

32. The most important feature of the demographic transition in the next half century, with respect to the Asia-Pacific region, is the rapid ageing of the population in countries that are still developing. Relative ageing of the old-age population itself is becoming a notable feature of the ageing process in the region. Another important dimension of the ageing process is the rising share of women in the older age groups.

33. Governments will increasingly be under pressure not only to devise innovative mechanisms to deal with issues arising from an ageing population but also to ensure the long-term viability of social welfare programmes, while minimizing the negative effects on the economy. The severity and complexity of such challenges will depend on the stage of economic development, the stage of ageing and the level of preparedness.

34. The fact that ageing is not a transient issue makes it necessary to respond to the ageing process in time. The diversity of ageing in the region means that different policy responses are called for in different countries depending on their current and expected levels of ageing. Fundamental changes in policy design, particularly in health and pension systems, will be necessary in many developing countries to minimize the pressures on service delivery, public expenditure and the overall growth potential of the economy. The ability to anticipate the demographic transition with a fairly high degree of accuracy provides countries with ample room to better prepare for the challenges posed by ageing and makes it a surmountable problem, provided that proper action is taken in time.

35. Responding to ageing in advance would enable countries to reap the "demographic dividend" produced by reduced fertility rates. It also gives countries whose populations are still young a time-bound opportunity to capitalize on their demographic conditions and benefit from the ageing of other countries by making productive use of their young labour force. However, collecting the demographic dividend would require that appropriate policies be in place.

36. The demographic changes that will be experienced by countries with ageing populations are likely to have a significant influence on public expenditure, in particular on the provision of pensions and health care. In many countries in the region, public pension schemes are pay-as-you-go systems with the financial burden accumulating over time. Rapid ageing of the population, with a shrinking labour force, will impose pressure on public expenditure on pensions as the number of retirees increases while the number of contributors to pension funds becomes smaller. The combination of factors will have a negative impact on pension funds unless adjustments are made and new solutions found to address the issue.

37. Converting unfunded pension schemes to funded pension systems is one option available to Governments. The advantage of moving towards funded pension schemes is that it enables Governments to minimize the economic costs of restoring long-run fiscal sustainability in the face of ageing-related pressures by spreading the required adjustment over a long period.

38. Pension reforms may also include the following measures (a) to increase coverage by introducing multi-pillar structures consisting of a mandated, publicly managed, defined-benefits scheme for redistributive and co-insurance objectives, combined with a privately managed and funded defined-contribution scheme for savings and retirement provisions on a voluntary basis for those who would like more protection in old age; (b) to give autonomy in decision-making to fund managers; (c) to provide opportunities for innovation in market instruments; and (d) to make pensions portable while improving labour-market flexibility.

39. Other options include increasing the age of retirement and removing incentives to early retirement. The impact of an increase in the retirement age on unemployment could be offset to some extent by implementing pension reforms along with labour-market reforms to increase the flexibility of the labour market.

40. The rapid ageing of the population in the region, in particular the ageing of the older population, would increase expenditure on public health. Consequently, health insurance would be an effective mechanism to finance the health-care needs of the elderly. However, at present only a few countries have private prepaid health insurance, which is otherwise almost non-existent in developing countries in the Asia-Pacific region. In many countries health-care expenditure is borne either by the Government or by individuals themselves. Health promotion throughout life would be a key factor for a healthy life during old age.

41. An important implication of the decline in the fertility rate to replacement level or below is the pressure on the family to care for the elderly. That demographic change can result in a 2-2-4 family structure, that is, a middle-aged couple who have to support two children as well as four parents. Such a family structure would compel present and future generations to look for alternative arrangements to take care of older parents. Social and fiscal policies could be used to promote filial responsibility for taking care of the elderly, along with public provision of institutional elder care, while creating an environment conducive to the provision of such services by the private sector and not-for-profit organizations. Low-income countries could also be promoted as retirement centres.

42. Older persons are often afflicted by poverty, owing to a host of factors, and poverty among the rural elderly, in particular older women, tends to be severe since formal or informal social security is largely absent. Women tend to live longer than

men, and rapid urbanization, which results in the migration of mostly young people to urban areas, leads to the isolation of older rural women in particular. With the expected decline in the potential support ratio from 10.9 per cent in 2000 to 3.8 per cent by 2050, the poverty aspects of ageing could become worse in the next few decades, underscoring the need for formal social support and elder care.

43. However, discriminatory treatment of older workers, particularly in relation to job recruitment, promotion and training, creates a stigma and social exclusion. The elimination of such discriminatory attitudes requires the creation of a climate of acceptance so that the elderly can be integrated into mainstream development. The implementation of national and regional action plans established in line with the Shanghai Implementation Strategy: Regional Implementation Strategy for the Madrid International Plan of Action on Ageing 2002 and with the Macao Plan of Action on Ageing for Asia and the Pacific 1999 could provide an enabling and supportive environment for ageing.

44. Reforms in the labour market are required to meet the challenges and seize the opportunities presented by population ageing. Liberalization of the labour market would need to focus on the effect of the declining labour force, productivity, migration and the adaptability of older workers to the present working environment. Labour markets should also respond to the needs of older workers, who will become an important component of the labour force in years to come. Job redesign, reorganization of the division of labour and the provision of a flexible working environment to meet the aspirations of those workers could be effective policy responses to an ageing workforce.

45. Historical population movements indicate that international migration can play an important role in offsetting many of the consequences of population ageing and labour shortages, although it may not be able to do so completely. The fact that human migration is a transnational phenomenon makes handling migration for the benefit of both the home and host countries a global issue. Formal arrangements between countries that export and import labour through bilateral or regional cooperation could benefit all parties as they could solve unemployment problems in exporting countries while meeting supply shortages in importing countries.

46. It is an opportune moment to explore the possibilities of bringing international human migration under a global framework for ensuring an orderly and rules-based flow of persons. A fresh look at the existing global frameworks for widening the scope of such initiatives for human migration, such as Mode 4 of the General Agreement on Trade in Services, would be a starting point.

47. Just as the population policies of recent years play some role in present-day demographic dynamics, population policy could also be used to reverse rapid fertility declines. Some countries have already taken steps to provide such incentives as housing priority for large and multigeneration families, flexitime for mothers to nurture their children, cash and fiscal incentives, childcare subsidies and enhanced child relief in income taxation. However, such changes should be implemented only through a carefully planned population policy since a quick reversal of the gains of low fertility could undermine the well-being of future generations.

IV. Microfinance in poverty reduction — challenges in Asia and the Pacific

48. The Asia-Pacific region has had a varied experience in providing microfinance to the poor, particularly in South Asia. Of the 179 validated microfinance institutions (MFIs) in Asia, 144 are in South Asia, and half of them are in Bangladesh alone. Microfinance institutions in South Asia have experimented with various microfinance schemes, such as the provision of credit and savings programmes targeting poor women, the mobilization of voluntary savings, the promotion of self-help groups and the involvement of private investment in microfinance. In East and South-East Asia, microfinance schemes range from large schemes involving formal financing institutions to others developed by non-governmental organizations that have a strong presence in those subregions. Four distinct types of microfinance institutions are operating in the countries of North and Central Asia: credit unions, non-governmental organization MFIs, commercial banks and microfinance banks. Microfinance in Pacific island economies is still in an embryonic stage, with no cases of sustained success in microfinance initiatives for poverty reduction. However, savings mobilization and provision of loans for consumption are becoming more significant as poverty becomes more evident in many economies of the subregion. Microfinance has gained in importance in poverty reduction efforts undertaken by developing countries in the ESCAP region, illustrated by the range of such initiatives that can be seen within the region. Nevertheless, the region still faces challenges in enhancing the contribution of microfinance initiatives to ensuring further poverty reduction, including the sustainability of microfinance, a lack of accountability and transparency and qualitative and quantitative assessment of the impact of microfinance on poverty reduction policies.

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Summary of the economic survey of Latin America and the Caribbean, 2004

Summary

The summary of the economic survey of Latin America and the Caribbean explores the main characteristics of the current economic recovery. In 2004, the economy of the region grew by about 5.8 per cent and per capita gross domestic product expanded by about 4.2 per cent. Section II reviews the prominent features of the region's economic growth, while section III discusses the region's economic performance against the backdrop of developments in the world economy. Sections IV and V focus on the economic performance of the region in 2004 and the outlook for 2005.

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I. Introduction

1. The Latin American and Caribbean economy grew by about 5.8 per cent in 2004, thereby outstripping the most optimistic forecasts, while the region's per capita gross domestic product (GDP) expanded by around 4.2 per cent. In 2005, GDP growth is projected to come in at approximately 4.5 per cent; this further upturn in per capita GDP will raise it to about 12 per cent above the average for the 1990s and to more than 6 per cent above its 1997 level, which was around where it had hovered until 2004.

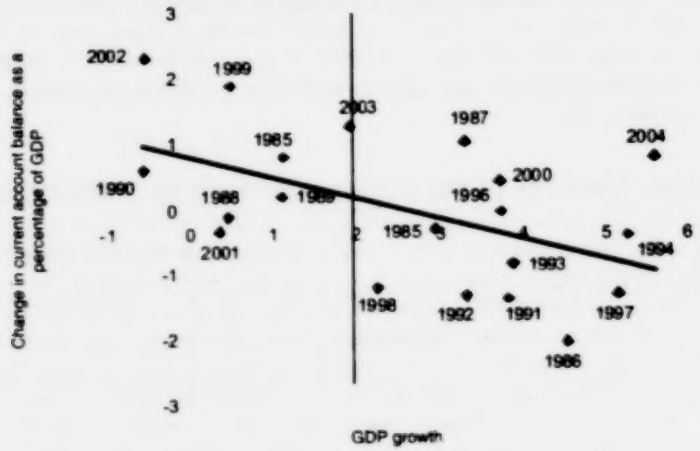
II. Prominent features of the region's growth in 2003-2004

2. One of the characteristics of the current recovery that makes it stand out from other events in the region's economic history is that, for the second year in a row, GDP growth was coupled with a surplus on the balance-of-payments current account in 2004 and that both of these aggregates were higher than they were the year before. In the past, when GDP was growing at a good pace, the current account was deteriorating, and when the current account was improving based on positive trade balances, this was because imports were contracting owing to slack domestic demand. A strengthening current account has been combined with GDP growth of over 2 per cent for the region as a whole in only three of the last 20 years; the other two cases were 1987 and 2000, but in neither of those two years was the increase in economic activity as strong as it was in 2004.[1]

3. A second and related distinguishing trait is that the sharp increase in GDP occurred at a time when the region was registering capital outflows, which, given the surplus posted on the 2003 balance-of-payments financial account, signals a sizeable downturn in the net capital flows received by the region. Decreases of this scale (usually regarded as constituting capital flight) have never before been seen in conjunction with an increase in GDP growth (see figure I). In the last two years, however, the external sector's strength has enabled the region to build up a credit balance in its transactions with the rest of the world, and much of the upswing in the GDP growth rate was associated with the buoyancy of exports (see figure II).

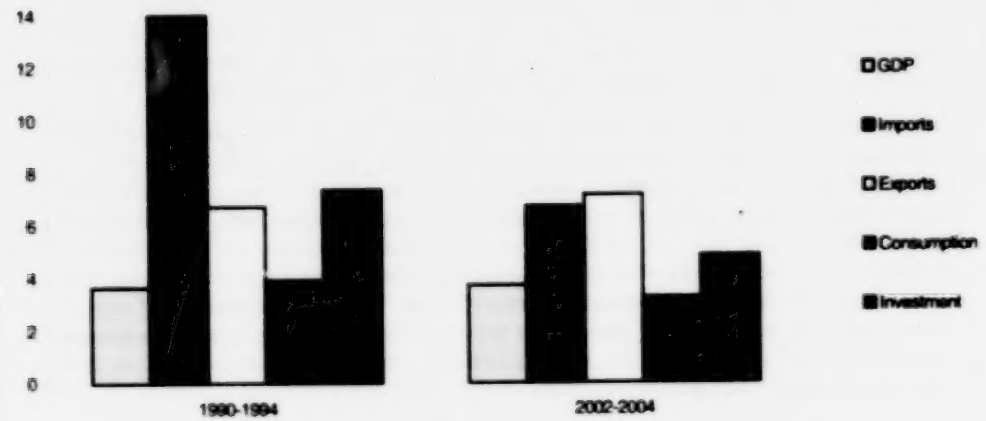
4. The counterpart to the current account surplus was, to some extent, residents' accumulation of assets in the rest of the world (which itself can constitute a form of capital flight). At the same time, however, some countries of the region trimmed down their stock of liabilities with non-residents, thus scaling back their levels of indebtedness, and the region's international reserves were on the increase. Furthermore, these events were accompanied by a downward trend in sovereign risk premiums, which are now approaching record lows. Thus, the net outflow of capital coincided with an expanding demand for regional financial assets. Given this unique combination of phenomena, the current situation clearly warrants analysis so that the factors underlying this growth trend can be identified.

Figure I
Latin America and the Caribbean: variation in the current account balance (as a percentage of GDP) and GDP growth



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure II
Latin America and the Caribbean: total supply and demand and annual growth rates



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

5. Since the start of this decade, the region has been witnessing an increase in the real exchange rate.[2] This upward trend (which has been steeper and stronger in South America, whereas in some of the Central American countries and Mexico, it was slower to take shape and has been somewhat less marked) has driven up the relative prices of tradable goods, thereby providing an incentive to expand exportable supply and hence to substitute such goods for imports and increase export activity.[3]

6. As was to be expected, the increase in the real exchange rate had the effect, on the one hand, of diminishing income levels, especially in the case of wage earners, and thus reducing total expenditure (thereby causing the exportable surplus to expand) and, on the other, of redirecting expenditure towards domestic production (thereby reducing imports). This is a plausible description of what occurred in 2002 and part of 2003, a period marked by very slow GDP growth and a hefty trade surplus that enabled the region to post a positive balance on its current account in 2003. Owing to the effects of the stabilization programmes implemented in previous years and of the recession and unemployment triggered by the adjustment, the reconfiguration of relative prices did not generate any major inflationary pressures. It should be noted that this general description is simply an attempt to trace the overall chain of events occurring in the region as a whole and thus does not reflect the considerable differences to be observed across countries.

7. Starting in 2003 but especially in 2004, favourable external conditions began to have a positive effect on the terms of trade. This, in turn, increased the purchasing power of export earnings and, since export activity was becoming more profitable, stimulated the growth of exportable supply. As a result, exports became the initial driving force behind the recovery of economic activity, in conjunction, especially in the beginning, with an increase in the supply of import-substituting domestic goods. Since the context for these events included high unemployment, low real wages, an underutilization of installed capacity and, in many cases, a recent history of instability, it comes as no surprise that domestic demand was slow to react.

8. Macroeconomic policy played an important role in this situation in two respects. First, the countries' central banks lowered interest rates in order to help spur the reactivation of their economies based on a relatively flexible monetary policy that also helped to sustain the nominal exchange rate. Second, the public sector maintained a high savings rate, and although this did nothing to facilitate the expansion of the economy (in the best of cases, it was a neutral factor), it did help to sustain the relative prices of tradables while at the same time allowing for a flexible monetary policy.

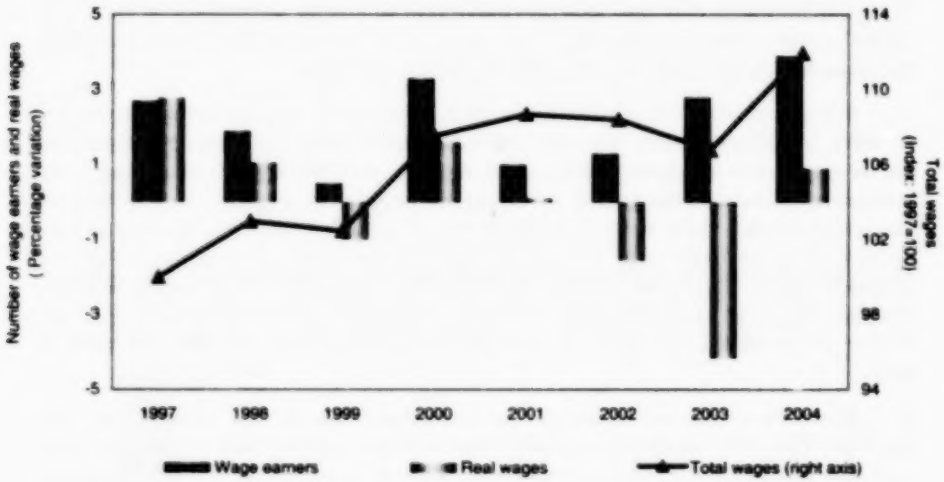
9. As exchange rates remained high and the impact of this strategy was, particularly from 2003 on, heightened by the improvement in the terms of trade, the upward trend in exports gradually began to be accompanied by an upswing in investment and, although the response of consumption was slower in coming (owing to low wage levels), GDP growth also started to pick up. This elicited an elastic response from imports, which began to rise accordingly.

10. This process, which had begun to take shape in 2003, firmed up in 2004. Exports expanded further; the upward trend in investment grew more solid, especially in tradables-producing sectors; and the region began to see a substantial increase in employment together with a slight rise in real wages (see figure III).

This fuelled an increase in overall consumption, although the consumption of durable goods had already begun to climb in response to the reduction in interest rates.

11. As a result, GDP growth accelerated, thereby spurring an expansion of imports and giving rise to a situation not seen in the region in at least the past 50 years: for the second year running, the region's economy grew while, at the same time, posting a surplus on the current account. What is more, unlike past episodes, the trade surplus that underpinned the positive balance on the current account was not the reflection of a drop in imports. In fact, imports exhibited a GDP elasticity of 2.7 and, in real terms, began to outpace export growth. Thus, the terms-of-trade effect gradually emerged as a decisive element in accounting for the trade surplus and, in conjunction with remittances, the surplus on the current account as well.

Figure III
Latin America and the Caribbean: total wages, 1997-2004



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

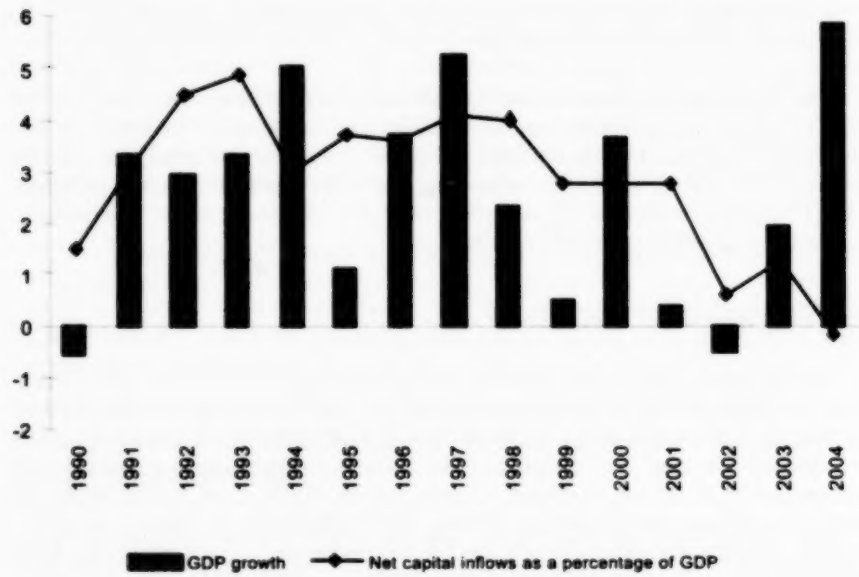
12. It is noteworthy that, with the sole exception of Haiti, all the countries of the region recorded positive growth rates in 2004. What is more, for only the second time in the last 20 years, the region's six largest economies all expanded by more than 3 per cent. This was coupled with an increase in gross capital formation although, when expressed as a percentage of GDP (18.9 per cent in 1995 dollars), this aggregate is still below the average for the 1990s. Meanwhile, private consumption grew more slowly than GDP, thereby helping to raise the region's savings rate.

13. Another striking aspect of the situation is that the region's economy grew at a time when it was registering a US$ 3.3 billion net outflow of capital, which — given the US$ 22 billion net inflow recorded in 2003 — translated into a net reduction in capital flows of around US$ 25 billion (1.3 per cent of regional GDP).

This was only the second time in the past 20 years that per capita income had risen when capital flows were shrinking. The other instance was in 1994, but in that case the significant decrease in net inflows of external capital was caused by the outflow of capital from Mexico in the final quarter, which had few consequences in terms of economic activity during that year but had a strong negative impact in 1995 (see figure IV).[4]

14. This situation stemmed largely from the sizeable current account surplus, which made it possible to lower domestic interest rates, thus discouraging capital inflows. The significant decline in the region's country risk (see figure V) — which came in at around 450 basis points at the end of 2004 and is now approaching the historical minimum of the series[5] — clearly indicates that these capital outflows are due not to an increase in the region's risk rating, but rather to the fact that the downturn in local interest rates has in many cases outpaced the decline in the cost of external financing.

Figure IV
Latin America: net capital inflows as a percentage of GDP and growth rates



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure V
Latin America: average sovereign risk spread

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of figures from J. P. Morgan.

15. The counterpart to these trends in the capital and financial accounts of the region's balance of payments was the current account surplus achieved in this period, which reflects not only the brisk growth of exports in real terms, but also the improvement in the terms of trade, whose impact on the purchasing power of export earnings was equivalent to a capital inflow of about US$ 24.2 billion. The increase in remittances added another US$ 40.5 billion.

III. The international backdrop

16. As discussed earlier, the region's strong economic performance was closely tied to developments in the international economy. World economic activity picked up speed in 2004, resulting in estimated global GDP growth of 4 per cent (well above the 2.6 per cent rate posted in 2003), while the expansion of world trade amounted to 10.6 per cent (versus 6.2 per cent in 2003). The United States of America and China have been the driving force behind the expansion in global economic activity, which has contributed to the commodity price hikes that have benefited many countries of the region, especially those in South America.

17. For 2004 as a whole, the United States' GDP expanded by just over 4 per cent (as against 3 per cent in 2003), although growth slowed down somewhat in the course of the year and is expected to continue to trend downward in 2005. Durable goods consumption and housing investment had been buoying the recovery, but they began to falter as the fiscal deficit swelled to 3.5 per cent of GDP and the balance-of-payments current account deficit reached 5.7 per cent of GDP. The shortfall has been financed largely with inflows from Asian Governments seeking to prevent their currencies from appreciating. The monetary policy stance changed in June, when the authorities began to raise the federal funds rate, and by the end of March

2005, this rate had risen to 2.75 per cent amid fears of an impending increase in inflation that could drive up interest rates.

18. China posted GDP growth of 9.5 per cent in 2004 (9.3 per cent in 2003), thanks to the continuation of the large-scale investments seen since 2003 and the stimulus provided by the expansion of exports. While measures taken by the Chinese authorities in 2004 in an effort to gradually cool down the economy reined in investment somewhat, it nevertheless soared by 25.8 per cent. In the fourth quarter of 2004, the strong expansion of exports (thanks, in part, to the depreciation of the dollar, to which the yuan is tied) took the place of the waning growth impulse generated by investment. In early 2005, mixed signals are being seen regarding the success of China's efforts to cool off its economy. Fixed investment has been climbing at virtually the same rate as in 2004, but import growth has been slackening — so much so, in fact, that imports actually decreased in February. For 2005, the authorities have set growth targets of 8 per cent for GDP and 16 per cent for investment. In view of the conflicting signals seen in the first two months of the year, however, the country's chances of meeting these targets are unclear.

19. Japan's economy grew by 2.6 per cent in 2004, which was below preliminary estimates. Two thirds of this increase was accounted for by the strength of exports, which were given a decisive lift by the expansion of Chinese and United States demand. Export growth tended to slacken as the year went on, however, and will be heavily influenced by events in these two markets during 2005 and by the relative strength of the yen. Meanwhile, the gross domestic product of the European Union grew by 2.2 per cent in 2004. This was a lower rate than the year before and no doubt reflected the sharp appreciation of the euro, which dampened the export growth that had been the main driving force behind the economy's fledgling recovery.

20. In keeping with its usual procyclical pattern, intraregional trade rose steeply as the regional economy expanded. The biggest increases in intraregional trade were seen in the Andean Community and the Common Market of the South (MERCOSUR), although exports by Mexico and Chile to other countries in the region were also up sharply.

IV. The economic performance of Latin America and the Caribbean in 2004

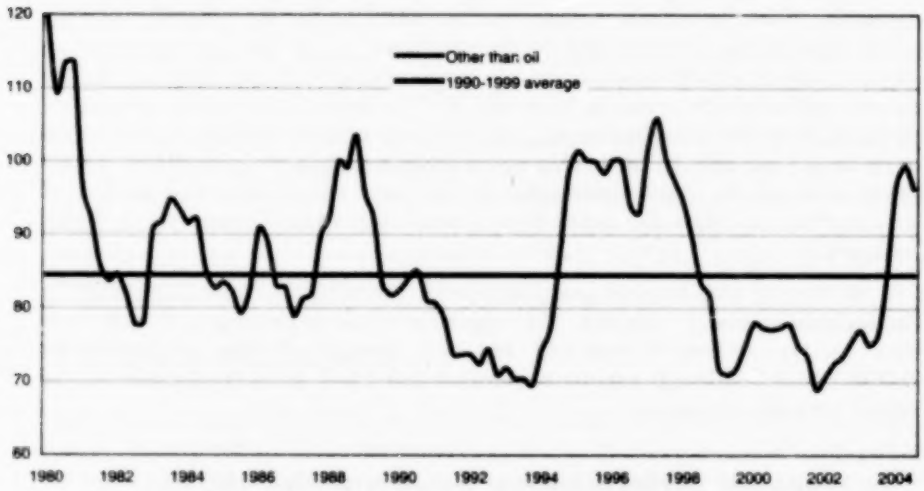
21. Thanks to current trends in the world economy and world trade, the improvement in the region's terms of trade that began in 2003, when they rose by 1.2 per cent, strengthened in 2004 with a positive variation of 5.6 per cent resulting from the 10.6 per cent upturn in export prices and the 4.7 per cent increase in import prices. Trends in commodity prices (especially in the cases of petroleum and metals) were a decisive factor in this regard. Figure VI illustrates the price trends for some of the region's export products.

22. Among net oil-importing countries, which are at a relative disadvantage, this negative effect was more than offset in the cases of Chile and Peru (which are metal exporters) by higher export prices. The combination of higher prices and larger volumes gave rise to an almost unprecedented boom in the region's merchandise trade. The sum of total exports and imports amounted to US$ 866 billion (44.3 per

cent of GDP) and represented a 22 per cent growth rate. Exports expanded by 23 per cent (an 11.2 per cent increase in volume and a 10.6 per cent rise in prices), while imports climbed by 20.9 per cent (increases of 15.5 per cent in volume and 4.7 per cent in prices). For the third consecutive year, the region posted a surplus on the merchandise trade account, with the positive balance rising at an average rate of some US$ 20 billion per year to reach the 2004 figure of US$ 60.63 billion (3.1 per cent of GDP).

23. The improvement in the terms of trade in 2004 brought an additional US$ 24.2 billion in foreign exchange into the region, which was more than the increase in the trade surplus and more than the upswing in the current account balance. In other words, had it not been for that improvement, both of these aggregates would have deteriorated slightly relative to their 2003 levels.

Figure VI
Latin America and the Caribbean: quarterly movements of non-oil commodity export prices, 1980-2004[a]



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Nominal prices, weighted by the share of each product category in the region's non-oil commodity exports in 1995.

24. For the second year in a row, the region posted a surplus on the balance-of-payments current account (US$ 18.22 billion, or 0.93 per cent of GDP). The factors accounting for the region's surplus were qualitatively identical to those that were at work in 2003, but their impact was even stronger in 2004. The positive components of the region's current account were the merchandise trade balance (US$ 60.63 billion) and current transfers (US$ 40.49 billion), for a combined balance of US$ 101.12 billion. The services balance and the income balance both showed deficits (US$ 15.11 billion and US$ 67.79 billion, respectively). The counterpart to the current account surplus was a capital outflow of US$ 3.3 billion, which was made up of net autonomous outflows (registered on the capital and financial

accounts, plus errors and omissions) of US$ 12.5 billion and net compensatory inflows (use of International Monetary Fund credit and exceptional financing) totalling US$ 9.2 billion. The variation in the region's autonomous flows can, in turn, be disaggregated into US$ 50.6 billion in net foreign direct investment inflows (2.6 per cent of GDP) and US$ 61.473 billion in portfolio investment and other capital outflows (3.1 per cent of GDP). As a result of these movements, the region accumulated US$ 14.86 billion in reserves (0.76 per cent of GDP).

25. With net capital outflows equivalent to 0.17 per cent of GDP (not counting workers' remittances) and a US$ 67.79 deficit on the income account, the region made outward transfers totalling US$ 71.1 billion (3.6 per cent of GDP) in 2004; this was more than twice as high as the level of outward transfers in 2003 (US$ 35.59 billion, or 2.1 per cent of GDP). If remittances are included in the calculations, then the region's outward transfers fall to US$ 30.6 billion, or 1.6 per cent of GDP, as compared to a net inflow of US$ 100 million in 2003.

26. The region's bond issues in 2004 amounted to US$ 36.383 billion, which was 4 per cent lower than the total for 2003 and equivalent to 38 per cent of total emerging-market bond placements. One noteworthy development was that, although the region has been losing ground to other emerging markets (especially Central Europe and Eastern Europe), some of the countries in the region have begun to issue long-term, local-currency instruments, and for the first time ever, the Inter-American Development Bank placed bonds that were denominated in the currencies of countries in the region. At the close of the first quarter of 2005, the region's bond issues represented 44 per cent of all emerging-market issues.

27. The region's macroeconomic performance in 2004 resulted in a significant improvement in the countries' fiscal accounts. This enabled their central governments to build up a primary surplus that, as a weighted average, was equivalent to 2 per cent of GDP, as against the 1.8 per cent surplus they had posted in 2003. The overall deficit (including interest on the debt) shrank from 1.2 per cent of GDP to 1 per cent. At a broader level of coverage that is more representative of countries that have a more highly decentralized public sector (Argentina, Brazil, Colombia and Mexico), the non-financial public sector's primary surplus increased, on average, from 3.2 per cent of GDP in 2003 to 3.8 per cent in 2004.

28. At least in the countries for which the relevant information is available, the fiscal out-turn for 2004 was primarily a reflection of increased revenues rather than of spending cuts. Revenues (measured as a percentage of GDP), buoyed by a generally favourable environment, moved in step with the level of activity, rising slightly above their 2003 level, while expenditure remained constant in real terms. The financial surplus made it possible to reduce debt-to-GDP ratios, which nonetheless remain very high, averaging 50 per cent but exceeding 60 per cent in seven countries of the region.

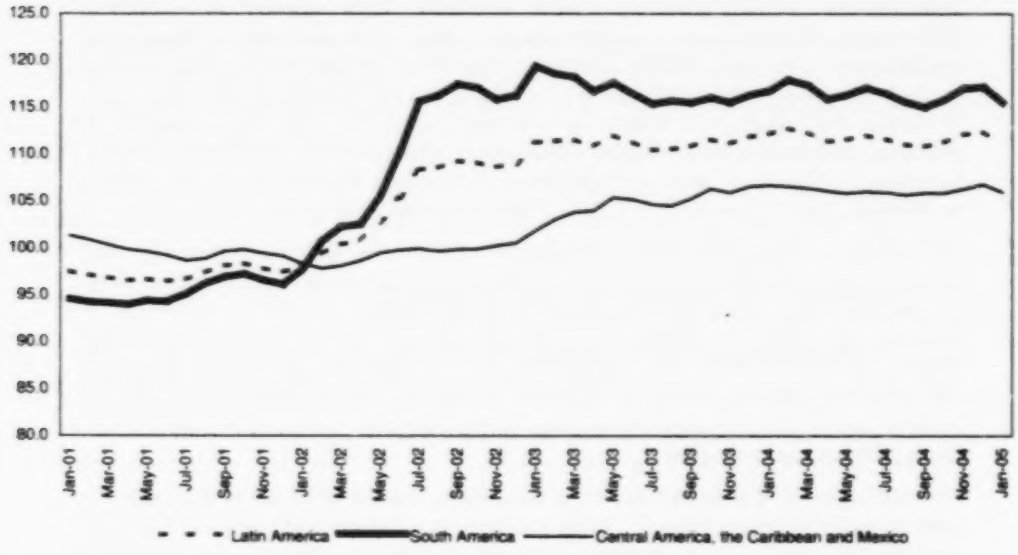
29. An analysis of movements in the benchmark interest rates set by the region's central banks in the course of 2004 reveals that, in general, monetary policy supported the recovery of domestic demand by lowering the cost of financing. Although inflation indices did climb during some months of the year, prompting the countries' monetary authorities to raise interest rates, real interest rates generally followed a downward trend and actually were negative in some cases.

30. This strategy was facilitated by the fact that public accounts were balanced and by the reduction in risk premiums and the decline in international interest rates seen early in the year. In this regard, the decision of the United States Federal Reserve Board to begin raising interest rates in the second half of 2004 and the expectation of further increases in the near future herald changes in regional interest-rate trends. The magnitude and sequencing of any adjustments will surely reflect developments in international financial markets, although these changes are likely to be relatively small.

31. The Latin American and Caribbean countries' exchange-rate policies, almost all of which were implemented in an environment free of constraints, succeeded in keeping real exchange rates relatively stable (see figure VII). This was no simple task, given the high level of commodity prices and the increase in export volumes, especially in the case of South America. This subregion witnessed a small real appreciation in effective exchange rates, especially in the second half of the year, together with a sharper appreciation against the United States dollar. In Mexico and Central America, on the other hand, real exchange rates were more stable; in fact, especially because of events in Mexico, they exhibited a tendency to depreciate somewhat in 2004, although this trend began to weaken in the second half of the year.

Figure VII
Latin America and the Caribbean: real effective exchange rates

(Simple averages, January 1999-December 2001 = 100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

32. Real exchange-rate movements in several Central American countries reflected a slight improvement in the terms of trade as well as the growing significance of remittances for a number of countries. The supply-side pressure exerted by these developments on the countries' exchange markets has coincided with growing competition from Chinese products in the United States market. This situation poses an economic policy dilemma for the subregion's central bankers.

33. One notable development in the region's labour market was that the pace of job creation picked up as the demand for labour strengthened. After a sharp upturn in the labour participation rate in 2003, the labour supply[6] expanded somewhat more slowly in 2004. As a result, at the regional level, the higher rate of job creation was reflected in a drop in the unemployment rate, which declined from 10.7 per cent in 2003 to 10.0 per cent in 2004. This was the largest region-wide decrease in unemployment since 1986. Unlike the situation in earlier years, job creation came to be concentrated in wage employment as the demand for labour generated by business enterprises strengthened. It should be pointed out, however, that this positive outcome was primarily a reflection of events in countries that were recovering from severe crises, rather than being the result of a region-wide improvement in labour-market indicators.

34. Since unemployment levels are still high in many countries, the upswing in economic activity did not bring about any major improvement in wages; the weighted average increase in pay levels in the formal sectors of a sample of 11 countries amounted to 0.9 per cent in real terms.

35. It is, however, estimated that the slight decline in unemployment, in combination with the small rise in wage levels, helped to reduce the region's poverty level from approximately 44.3 per cent in 2003 to about 42.9 per cent in 2004. This nonetheless high poverty rate reflects the fact that, in the region's urban areas alone, 16.4 million people are unemployed. In addition, a large number of employed persons who work in the informal sector or are underemployed have incomes that leave them below the poverty line.

36. The rate of inflation continued to trend downward, reaching a region-wide average of 7.4 per cent compared to 8.5 per cent in 2003 and 12.1 per cent in 2002. Although trends in international commodity prices, particularly for food and petroleum, exerted upward pressure on price indices in the first half of 2004, in the second half these pressures abated and inflation showed a quite widespread tendency to decline.

V. The outlook for 2005

37. The international environment is expected to be a positive one for the region in 2005, albeit less so than in 2004, as world economic growth is projected at around 3.25 per cent.[7] The probable slowdown in the United States economy and the recessionary and inflationary effects of high oil prices are the main factors underlying this forecast. Although it is not yet known exactly how much or how fast the Chinese economy will cool down, that economy is likely to grow more slowly in 2005 than it did in 2004. Growth is also expected to slacken in Japan and the euro area. The risks currently facing the world economy are associated with the imbalances in the United States economy and their potential impact on interest rates and the value of the dollar, the possibility of an abrupt descent in China's growth

rate and the uncertainty surrounding the oil market and the possible adoption of protectionist measures, especially in the United States.

38. In view of this external environment and events in the region's economies, in 2005 the region is expected to remain on the growth trend that began two years ago, although its rate of expansion is likely to be somewhat slower than in 2004. Economic activity is expected to pick up, resulting in an average growth rate for the region of 4.5 per cent, which would raise per capita GDP by about 3 per cent (see table).

Latin America and the Caribbean: economic growth

Country	*2003*	*2004*	*2005[a]*
Argentina	8.8	9.0	6.5
Bolivia	2.5	3.8	3.3
Brazil	0.5	5.2	4.0
Chile	3.3	5.8	6.0
Colombia	4.0	4.0	4.0
Costa Rica	6.4	4.0	3.5
Cuba	2.6	3.0	4.0
Dominican Republic	-0.4	2.0	3.0
Ecuador	2.7	6.6	3.4
El Salvador	2.0	1.5	1.5
Guatemala	2.1	2.5	3.0
Haiti	0.4	-3.0	2.0
Honduras	3.2	5.0	4.2
Mexico	1.2	4.4	3.8
Nicaragua	2.3	4.3	3.5
Panama	4.3	6.0	4.5
Paraguay	3.8	2.9	3.0
Peru	3.8	5.1	4.5
Uruguay	2.5	11.8	6.0
Venezuela (Bolivarian Republic of)	-7.6	17.3	5.0
Latin America	1.8	5.8	4.5
Caribbean	3.4	4.1	4.0
Latin America and the Caribbean	1.8	5.8	4.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Projections.

39. The question arises as to whether the growth observed in the region is based on a solid foundation that can sustain it over the medium term or whether the region has simply taken advantage of extraordinarily favourable conditions that may, as noted above, take a turn for the worse in the near future.

40. Reasons for believing that the region's economies may continue to grow, albeit perhaps at lower rates than in 2004, include the existence of sound domestic macroeconomic frameworks, the maintenance of high real exchange-rate parities and their effect on the region's exportable supply, the still low external dependence of demand in comparison to other components, the influence of the multiplier effect on the growth of demand and the possible existence of repressed consumer demand which, having thus far been held back by high unemployment and low real wages, may break free of those constraints if 2005 proves to be a third straight year of economic growth. Furthermore, the region has a sizeable current account surplus that should allow it to sustain relatively high growth rates, while no significant tension is foreseen in the external sector. Nevertheless, it should be remembered that, not long ago (from 1996 to 1998), the region experienced a comparable episode of high international commodity prices which also enabled it to build up a current account surplus, but the effects proved to be short-lived. The greatest threats in the short run appear to be the possibility that some of the imbalances currently in evidence in the international economy could trigger a traumatic adjustment that could drive down world GDP (and, therefore, demand for the region's exports), and heightened global uncertainty.

41. In any event, the region should seize this opportunity to alter the basis on which it participates in the world economy. In the medium term, this will require the region (and especially South America) to reduce its reliance on low-value-added natural resources and to correct its export profile, which is overly dependent on low wages, particularly in the case of Central America and the Caribbean and, to a lesser extent, Mexico.

Notes

[1] The upturn in the terms of trade is one factor that the three episodes have in common; the major difference between the current situation and the most recent of the other two cases is that, in 2000, the improvement in the terms of trade was almost wholly due to the increase in oil prices.

[2] The nominal exchange rate is defined as the number of units of a given country's currency that must be surrendered in exchange for one unit of foreign currency at any given point in time. A domestic currency depreciates (appreciates) in nominal terms when, at that point in time, more (fewer) units of that currency must be surrendered in exchange for one unit of the foreign currency than during a specified reference period. The real bilateral exchange rate index is calculated by deflating the nominal exchange rate by the ratio between the inflation rates of the two countries. A currency depreciates (appreciates) in real terms when the real bilateral exchange rate index rises (falls).

[3] Generally speaking, the countries of the region can sell the sum total of their output without influencing prices. There are some exceptions, however, in cases where Latin America is the supplier for a sizeable portion of the total market for certain export commodities. Be this as it may, the expansion of exports reflects a number of longer-term factors, including the technological modernization efforts and investments undertaken in the region in past years.

[4] In 1994 there was a net capital outflow of approximately US$ 19 billion, but if it had not been for the net outflow of somewhat more than US$ 33 billion registered by Mexico in the final quarter of that year, the net flow would have been positive.

[5] Excluding Argentina, the region's average country-risk spread is about 360 basis points.

[6] The labour supply is represented by the economically active population, whose size is determined by population growth and the labour participation rate.

[7] *World Economic Situation and Prospects 2005* (United Nations publication, Sales No. E.05.II.C.2).